

Title: “Does the existing Corporate Governance structure and strict Legal Framework, affect the strategic decision-making of CEOs?” The case of Portugal; a qualitative study on business ethics

Field of study: Corporate Governance, Business Ethics, Corporate Law

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## **Abstract**

This thesis is a case study on Corporate Governance and Business Ethics, using the Portuguese Corporate Law as a general setting. The thesis was conducted in Portugal with illustrations on past cases under the Business Judgment Rule of the State of Delaware, U.SA along with illustrations on current cases in Portugal under the Portuguese Judicial setting, along with a comparative analysis between both.

A debate is being considered among scholars and executives; a debate on best practices within corporate governance and corporate law, associated with recent discoveries of unlawful investments that lead to the bankruptcy of leading institutions and an aggravation of the crisis in Portugal. The study aimed at learning possible reasons and causes for the current situation of the country's corporations along with attempts to discover the best way to move forward.

From the interviews and analysis conducted, this paper concluded that the corporate governance structure and legal frameworks in Portugal were not the sole influencers behind the actions and decisions of Corporate Executives, nor were they the main triggers for the recent corporate mishaps. But it is rather a combination of different factors that played a significant role, such as cultural and ethical aspects, individual personalities, and others all of which created gray areas beyond the legal structure, which in turn accelerated and aggravated the corporate governance crisis in the country.

## List of abbreviations

BBVA	Banco Bilbao Vizcaya Argentaria
BdP	Banco de Portugal
BES	Banco Espírito Santo
BJR	Business Judgment Rule
BOD	Board of Directors
CCG	Comparative Corporate Governance
CEO	Corporate Executive Officer
CG	Corporate Governance
CIN	Corporação Industrial do Norte
CMVM	Comissão do Mercado de Valores Mobiliários
COO	Chief Operating Officer
CPI	Comissão Parlamentar de Inquérito
CRGI	Coatings Research Group Incorporated
ESFG	Espírito Santo Financial Group
ESI	Espírito Santo International
GES	Grupo Espírito Santo
IPCG	Instituto Português de Corporate Governance
JM	Jeronimo Martins
NED	Non-Executive Director
OECD	Organization for Economic Co-operation and Development
PSD	Partido Social Democrata
PT	Portugal Telecom
PwC	PricewaterhouseCoopers

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## **1. Introduction and Motivation**

Post the fall of Banco Espírito Santo and recent events impacting Portugal Telecom, changes resulted in the Portuguese corporate canvas, leading to the underlying question and hypothesis of this study, which was to investigate if both corporate governance and the judiciary system in Portugal played a role in executive decision-making and corporate investment, and if so how this impact takes place and what are the results and the way to move forward. The study was conducted in Portugal with a comparative analysis against a more liberal system in the state of Delaware, USA with regards to the Business Judgment Rule, in order to better analyze the impact of the judicial system.

The thesis is based on a qualitative analysis, involving illustrations from Portuguese firms along with one-to-one interviews in Portugal with individuals from the corporate world, the banking industry, and academic professionals. The study indicated that although corporate governance and the judiciary system played indeed a role on executives' action plans and management strategies and on the basis of a board's critical decision-making, other areas such as the tax authorities, internal management policies of a firm, the balance of responsibility and power and most importantly the actual application and supervision of rules and regulations, turned out to play even bigger roles.

The analysis of the Business Judgment Rule of Delaware State in America, led to two contradictory views in this study. On one hand the rule set up a fairly straightforward method to managing the accountability of executive officers towards their companies, whereas on the other hand, the reasoning of this regulation was proven to be more of a gray area difficult to assess. Executives and members of boards in Portugal – as indicated in the interviews – did not favor this rule and seemed to disapprove the suggestion of a more lenient judiciary system, given that recent events call for more strict measures in their view.

Another finding of the study was that investments and risk-taking initiatives had decreased as a result of the crisis and a substantial fall in the liquidity of companies in Portugal and the European Union as a whole. Interviewees noted that executives have become more cautious post the crisis as a result and as they attempt to salvage their firms. This crisis provoked a change in risk-taking behaviors and the development of strict policies for investment decisions by surveillance committees. In addition, financial institutions have also become very risk adverse and are required to follow strict regulations within the EU as opposed to the history prior to the crisis when the loan to deposits ratio was largely unbalanced leading to large mismatches between the maturity of loans versus deposits. This indicated that external factors related to the economy affect executive management at large.

The interviews and research undertaken for this study presented an additional issue requiring further discussion, which is the unbalanced power, typically concentrated in the hands of singular executives. This appeared to be a cultural trend that stemmed from 48 years of a dictatorship in Portugal, where many individuals were allocated positions of power with no rigorous assessment of their candidature or monitoring of their performance post allocation. Companies are currently battling this problem by breaking down institutional power into committees and undertaking decisions collectively, to ensure transparency and mitigate control. The overall purpose of this study is to lead to further research on various factors impacting executive management and in turn Portugal on a larger scale.

## **2. Statement of the problem/research**

The main purpose of this paper is to raise and answer questions around the corporate environment, the structures of corporate governance in Portugal and their ties with the judicial system. With the unfolding of a continuous financial crisis in Europe since 2008 and its effect on Portugal, poor corporate governance has been led continuously to failures and weaknesses. Ethic reports such as that of BBVA<sup>1</sup> state that companies in face of the catastrophes did not set up effective corporate governance systems and that regulators did not take the necessary precautions to monitor the risky actions of corporate executives, particularly in the financial services sector. Further more risk management systems have also failed in many of the recent cases to face such crisis; and their failure was widely attributed by media reports, researchers and interviewees to negligence and to bad faith of board directors and executives.<sup>2</sup>

In recent times, a few exclusive and influential figures in the political and corporate scene, have been subject to accountability over business decisions and investments that lead to unfavorable results—which is unique, considering the protective legal system in Portugal where prosecuting top management executives was quite unheard of – until the recent cases of Ricardo Salgado, ex-president of Banco Espírito Santo and Zeinal Bava, ex-CEO of Portugal Telecom SGPS.

These events led to further inquiries concerning the Portuguese corporate law, its level of lenience, its applicability and its impact on the governance of companies. For instance, are risk-taking executives able to follow mandatory protocols and act within the law? What seems to be their projection of future plans for their companies and the economy? What are the levels of compliance within corporations in Portugal? What are the perceptions and reactions of executives towards judiciary mandates? Companies in Portugal along with the institutes for Corporate Governance and the judiciary system are in need of identifying the reasons, triggers and motives, which incentivize healthy investments and appropriate levels of risk-taking strategic decisions, in order to further, promote lawful behavior and efficient implementation of systems within all corporations and institutions, all while encouraging executive management to perform to the best of their knowledge.

## **3. Relevance of the problem/research for business organizations**

It is continuously difficult, if not near impossible, for organizations to define a "one size fits all" solution to improve executive and board performance. This leaves companies with the responsibility of continuously improving their management and board practices through internal voluntary tailor-made initiatives. (Bratton & McCahery, 2000)

The customization of corporate governance structure is a critical aspect of the agency trade-off between executives' personal objectives. The main goal of an institution is revenue maximization or

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<sup>1</sup> Banco Bilbao Vizcaya Argentaria, S.A. a multinational Spanish banking group, which launched an initiative called "Open Mind" with the aim of generating and spreading knowledge. The report mentioned is that of "Values and Ethics for the 21<sup>st</sup> century"

<sup>2</sup> OECD (2014), *Risk Management and Corporate Governance*, Corporate Governance, OECD Publishing. <http://dx.doi.org/10.1787/9789264208636-en>

more explicitly the return on investment for the shareholders. Much of that is the responsibility of management's corporate executives towards shareholders and company owners and relies on their strategic decision-making and investment decisions. The most important base that sets forth the path for other goals is the creation of competent boards and efficient regulations that are capable of objective and independent monitoring of the management of the company. This study helps Portuguese companies identify the importance of setting up processes and committees and monitoring corporate executives and managers, along with required ethical standards, responsibility and incentives to attract the best acumen and maintain a healthy future prospect of the firm and avoid any bankruptcy or any legal problems in ongoing difficult times of an ongoing crisis.

Further objectives of this study are to frame the corporate governance recent cases in Portugal within the legal/institutional context, without forgetting that these cases are also engulfed by the economic situation of the country. We claim that the cases are related not only to the specific timing of the financial crisis in the Portuguese but they run deeper in the structural economic settings of the country. For instance, the individual corporate governance solutions set up by Portuguese companies are a response to common risk taking behaviors of managers in their relationship with the shareholders within the particular protection provided by the local law.

Companies and corporations are always questioning the way to move forward, the best way to operate within legal systems for both the benefit of a company and of the economy. From a political aspect, one seeks to better understand corporate governance and the legal system in Portugal with both its benefits and implications with regards to the actions of executives. Companies are also in need of understanding the actions and the reasons behind the management performance of their Corporate Officers, in order to best evaluate them.

In Portugal, it is becoming increasingly important for the purpose of good practice to create clear distinctions between the several functions and roles of executives. Beyond the corporate law setting and even the very customized individual corporate governance environments created by the companies, there is the question of real day-to-day practice and enforcement of all these rules. Significant space is used to improvise, to adapt and to bend these rules and regulations, between the personal exercises of the different executive roles. Recognizing the existence of gray areas, there have been initiatives (such as the rule "to comply or explain" – which will be further explained in the literature review) associated with attempts to bring transparency to particular or exceptional situations.

#### **4. Literature review**

##### **4.1. Corporate Governance**

The governance of corporations has been in the focus of business analysts since the 1990s, with the attention of media sources helping to drive this interest. The starting point of academic thinking regarding the concepts of corporate governance and associated corporate finance began much earlier and emerged from a book written by Berle & Means (1932), documenting the separation of both ownership and power of control in the United States and the creation of substantial managerial discretion by shareholder dispersion that is easily subjected to exploitation. The most common definition of corporate governance in the world of economics according to the more recent surveys of

Shleifer & Vishny's (1997) and Becht et al. (2002) is that it relates to "ways in which financial suppliers assure themselves of getting a return on their investment." However in the research there is no sole definition that encompasses the practice and theory of corporate governance as a whole.

As Clarke (2011) puts it, corporate governance is perceived in various ways depending on the viewer and its definition varies according to what the definer is interested in. The simplest definition set by the British committee on the financial aspects of Corporate Governance in a report of Cadbury<sup>3</sup>, describes corporate governance as "the system by which companies are directed and controlled". While Margaret Blair defines corporate governance as "the whole set of legal, cultural, and institutional arrangements that establish what publically traded corporations can do, who controls them, how that control is implemented, and how the risks and returns from their activities are allocated." (Blair, 1996) Institutional economists maintain an even narrower view of corporate governance such as the concept of a company's relationship with its stakeholders, which covers all institutional structures that participate in the processes of a firm's goods and services. (Williamson, 1985 & Clarke 2011)

Another scholarly view is that which is concerned with financial and agency issues, adding a policy section to prevent the exploitation of investors and funders by management. It revolves around the dynamics between shareholders, the board of directors and executive management. (Jensen & Meckling, 1976)

Corporate governance is deeply rooted in national economic structures and corporate law and corporate finance are in turn, strongly rooted in these structures. (Berglöf et al., 1997)

Furthermore, current corporate governance studies are focusing further more on Comparative Corporate Governance "CCG", partly stemming from researchers realizing its significance and the importance of understanding how corporate matters are done globally. The financial crisis has also led to questions around traditional structures of corporate governance and research on how some countries apply better structures than others. (Clarke, 2011) Moreover, the study of Comparative Corporate Governance is becoming an empirical part of Corporate Law study. CCG typically focuses on agency problems between investors and executive management as well as shareholder versus stockholder theories on benefits of each through the corporation. (Clarke, 2011)

To better understand corporate governance and its evolution, it is imperative to take a look at how firms are financed and how the legal environment they are present in impacts their activity and stature.

#### **4.2. Corporate finance**

There is higher consensus across countries about implications of corporate finance on corporate law, particularly in Europe. Internal generated capital generally provides most of the investment funds to firms and bank loans have been the most important external source of finance (Mayer, 1990).

According to Berglöf et al., (1997) the role of various corporate institutions such as the general shareholders' meeting and the board of directors, are largely influenced by the dominant form of financing. Different forms of financing place different demands on the legal environment and institutions involved. Berglöf et al., (1997) demonstrated in their study that financial structures somehow influenced the evolution of the general legal system. These structures identify and set the nature of conflict between a firm and its investors and among investors themselves, and then in turn,

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<sup>3</sup> The report of the committee on the Financial Aspects of Corporate Governance and Gee and Co. Ltd. 1<sup>st</sup> December 1992.



this nature impacts the structures and functions of both the board of directors and the shareholders' meeting. Above and beyond, lawmakers have been becoming less inclined to let courts rely on information from markets with increasingly poor liquidity. Berglöff et al. also further demonstrated how corporate law affects corporate finance as well, meaning how the legal framework does influence financial arrangements and tradeoffs between corporate governance and liquidity, both directly through restrictions on the size of incentives or types of control mechanism and indirectly through the impact on investors' incentives to take on control. So as to summarize Berglöff et al.'s conclusion, corporate finance and corporate law are interrelated.

#### **4.3. Corporate Law**

At the turn of this century, corporate law, according to some scholars, was said to be approaching the end of time. (Hansmann & Kraakman, 2000) According to them the winning school of thought – the conservative school - establishes the primacy of the shareholders in regulating the “nexus of contracts”, rendering corporate law as an almost marginal accessory. This school of thought believes that the state's primary role in corporate governance is limited to provide efficient default rules protecting shareholders while the few mandatory legal rules that restrict corporate behavior are subject to evasion by choice of form. All rules of corporate activity can effectively be set by markets, and no longer necessarily by law.

The other school of thought, progressive corporate law had been overcome, along with its preference for state imposed regulations that limit excessive pursuits of revenue and employee promotion and customer and community voice in corporate governance. Progressive corporate lawyers even concurred that shareholder primacy would dictate corporate practice in the twenty-first century (Tsuk, 2003 & Winkler, 2004)

However, poor accounting practices and the mismanagement of several prominent companies like Enron and WorldCom in the United States along with other public corporations reintroduced questions around the markets' ability to self regulate corporations. These scandals renewed the debate on how to control corporate executives who are eager to use firms for individualistic benefits that come with disadvantages for stakeholders and lead to a reform of corporate law (Roe, 2003), of which the Sarbanes-Oxley Act is the most prominent example.

Historically, when looking at the European Union, countries span a wide range of legal origins. Comparative legal scholars distinguish between two law systems: common law – originated from judges – and civil or code law – initiated by scholars and legislators as per the Traditional Roman Law. (David & Brierley, 1985) Further distinctions have been made between French and German civil law countries. All these differences in legal origin have influenced corporate laws and their enacting institutions, along with deeply concealed differences in legal frameworks. Moreover, the nature of a firm – public or private – generates further substantial differences between how corporations are managed, regulated and monitored.

There are two broad corporate law traditions in Europe: the first is a company based system where the firm is a legal entity with a focus on its relationship with its investors and the second is an enterprise based system where emphasis is based on physical property, with a broad view on stakeholders. (Wymeersch, 2005) Further elaborations are made later in this study on Portuguese Corporate Law.

#### **4.4. Role of the CEO and Board**

Generally a Corporate Executive Officer "CEO" is viewed as being the individual at the top of the corporation's pyramid. However corporate governance researchers have long realized that this common perception was not correct. As per Aisner & Lorsch (2013), the general structure of a corporate governance system dictates the following hierarchy: the CEO reports to the board of directors, which in turn focuses on critical matters such as CEO performance and succession, corporate strategy, and executive compensation.

The board of directors of an institution is deemed the highest control apparatus, accountable for the monitoring of actions taken by top executive management (Fama & Jensen, 1983). Under the dominant corporate governance model, the main role of the board is to supervise the comportment and management of corporate executives.<sup>4</sup> The board of directors exists primarily to address any conflict of interest in addition to the numerous regulatory requirements they normally assist with (Hermalin & Weisbach, 2003). Ultimately the shareholders appoint the board directors and in turn are represented by them.

The relation of power and control between a company CEO and its board of directors is further elaborated in the research of Shivdasani & Yermack (1999), where they examine the role of a CEO in the selection of directors of the board. Results of the study showed consistent evidence that firms selected directors who were less likely to supervise their CEO or inspect their actions, when the CEO themselves were involved in the selection process of the board. This emphasizes all the more that CEOs ought to be totally independent from the selection of their company's board of directors. Moreover, according to Cheng & Courtenay (2006), companies with a high number of independent directors, have in return significantly higher levels of disclosure compared to companies with dependent or management-involved directors. Another paper by Srinivasan (2005) reaches alternative conclusions where independent directors were subject to higher reputation costs in the event of the detection of falsified financial information submitted by the company.

#### **4.5. Corporate Governance Obstacles**

The basic starting point to understand the root of problems emerging from corporate governance is the "agency problem"<sup>5</sup>, that is the credibility problem entrepreneurs and executives come to face when seeking the contribution of investor funds. (Berglöf et al, 1997)

In the study of Berglöf et al. (1997) the scholars confirmed that: "The role of corporate governance in that respect is to ensure that market signals and all relevant information are actually translated into investment decisions and communicated to investors."

When classic agency problems cannot be eliminated, and competition itself is not sufficient to restrain management, corporate governance is the key commitment on behalf of a firm towards not only its investors but also all stakeholders<sup>6</sup>.

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<sup>4</sup> Toward a Public Enforcement Model for Directors Duty of Oversight, Renee M. Jones & Michelle Welsh, Vanderbilt Journal, March 2012

<sup>5</sup> <http://www.investopedia.com/terms/a/agencytheory.asp>

<sup>6</sup> As stated in the interview with Duarte Pitta Ferraz.

#### **4.6. Corporate Governance Reform**

Calls to reform European Corporate Governance began with the emergence of corporate scandals in 1997 throughout Germany, Spain and Italy along with other less documented corporate governance failures (Berglöf et al, 1997).

Another source that pressured corporate governance reform was the integration of capital markets in Europe which led to the perception that different corporate governance structures could prevent investors from being able to take advantage of the single market concept created in Europe. Moreover, European countries have been receiving external pressure for reform, particularly from the United States, through the increased presence of institutional investors in Europe, and the increasing of competition for global savings among recipient countries as markets generally have become more global. In response to these calls, many countries have rewritten their corporate laws and reviewed the requirements for listed firms in the late nineties.

"Corporate governance currently appears to be at its lowest level in business history."<sup>7</sup> Accounting and financial scandals of unprecedented scales have emerged in the US and Europe and resonated worldwide. Most of these scandals have been attributed to poor corporate governance standards and practice. (Detomasi, 2006)

As severe agency problems continue to occur, calls for corporate governance reforms have been issued. In the same manner, numerous corporate problems along with the world crisis reinforced the questioning behind whether managers and executives were monitored or not. (Tirole, 2005)

The conclusion here is that such, real corporate governance change and reform will necessitate fundamental transformations in both legal and economic systems on national levels. (Berglöf et al, 1997)

#### **4.7. Corporate Governance and risk-taking**

Building on the works of John et al., (2008) linking corporate governance with risk-taking, better investor protection has proven in most cases to induce firms to undertake riskier yet financially healthier and value-stimulating investments while poor investor protection created a need for controlling owners with risk adverse strategies. (Bukart et al., 2003) A trend currently investigated in the study of corporate governance is that of "how constraints on corporate decision makers' self-interest pursuit, lead to corporate value maximizing behavior and healthier management." Other lines of thought such as (Morck et al., 2000) demonstrate how poor investor protection can lead to low levels of informed risk arbitrage while another reasoning by Durnev et. al. (2004) demonstrates how low levels of informed risk arbitrage lead to poor corporate governance, insignificant resource allocation and low productivity development.

Some argumentative studies supporting a positive correlation between corporate risk-taking and investor protection, such as that of corporations in poor investor protection countries, who have dominant insiders with significant cash flow rights and private benefits in firms they run. (John et al., 2008) According to Shleifer & Vishny (1986), dominant shareholders also tend to have authority and incentives to reduce managerial discretion, hence, a reduction in the presence of dominant shareholders may lead to greater managerial discretion and more conservative investment policies,

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<sup>7</sup> Quote taken from Professor Duarte Pitta Ferraz business ethics class notes, 2014.

leading in turn to a negative correlation between investor protection and risk-taking. Another supportive argument by Stulz (2005) is that in poor investor location nations, a pyramid of companies are controlled by dominant owners who coordinate risk-taking at lower levels of the company and channel the benefits to upper levels of management, while leaving lower levels to absorb any potential risk of loss.

The research study of John et al., (2008) involved an experiment to examine the relationship between shareholders' rights and a company's risk-taking, using firm level and country level from 1992 to 2002 for 39 countries. In all cases, they found a positive relationship between shareholder protection and firm level risk taking and also firm level growth, while the influence of non-equity stakeholders' barely support their success in reducing corporate risk taking. The results also indicated that the measure of risk was positively correlated with economic growth and total productivity growth. As a complement to their findings, they also analyzed U.S firms for detailed firm level data on corporate governance and measures of investor protection, which in turn enabled them to assess variations in investor protection and transparency on firm-level risk-taking.

## **5. Background**

### **5.1. Corporate Governance**

Corporate governance is broadly defined as the structure of rules, processes and practice under which a company is directed and coordinated (Pugh, 1990). It involves essentially the balance of interests of the stakeholders in a company including: shareholders, management, employees, customers, suppliers, financiers, government and the community. Corporate governance also provides the framework for a company's goals and objectives, and it encompasses every management area; from action plans to internal reviews and performance measurement to corporate disclosure.

Corporate governance became an even more important issue following the introduction of the Sarbanes-Oxley Act in the United States in 2002, an act that aimed to restore public confidence in companies and markets post accounting fraud and the bankruptcy of high profile companies. Most companies attempt to obtain the highest level of corporate governance, demonstrating good corporate citizenship through ethical behavior and sound governance practices.

### **5.2. Corporate Governance in Portugal**

In Portugal, the corporate governance code is set by the IPCG (Instituto Português de Corporate Governance), the Portuguese Institute of Corporate Governance, composed of selected members and individuals in charge of ensuring the solid practice of boards and executives in companies and their definition and application of the corporate governance code. The bylaws of the code are comprised of 25 articles defining the composition of the institute and its members along with the institute's purpose and selected roles and bylaws, of which the following chapters and sections can be considered in this study (Appendices no. 10.1):

Looking at Chapter 2; subject, article 3, states the responsibility of the IPCG in researching and disseminating corporate governance principles and in developing all related activities of which matters related to corporate governance such as good management practices are covered, including the definition of professional qualifications for shareholders, partners, the board of directors, and other

relevant stakeholders. The institute is also responsible of fostering competent performance within the activities of the relevant stakeholders and providing training. Most importantly the institute is responsible of monitoring and participating in national and international institutions regarding its subject and ensure that legal individuals adopted the laws with transparency, accountability and fairness. The institute is also responsible for educating all relevant parties on corporate governance.

Moving on to Section IV detailing the role of the Supervisory Board of the IPCG, article 23 states that the duties and responsibilities of the supervisory board, in specific, are to ensure compliance with legal provisions, provide an opinion on management reports, balance sheets and annual accounts and on ordinary budgets and amending budgets and decide on matters to which the General Assembly, the General Council or the Directorate decide to hear.

The above sections indicated briefly some of the responsibilities of the IPCG in sufficiently monitoring boards and setting the appropriate mandates and ensuring an efficient follow through. As far as the Corporate Governance code in Portugal is detailed, not all mandates and procedures are followed closely, which will further be highlighted in the case of the boards some Portuguese firms, currently under investigation.

In Portugal, as in the EU, listed companies are required to prepare a yearly report with a detailed description of their governing structure. In Portugal, there are two structures or formats for a company's Corporate Governance:

- 1) The Dual system; which is comprised of the "Conselho Geral & Supervisão" – the board where the CEO sits – and the Executive committee
- 2) The single board comprised of both Executive and Non Executive members, such as the structure of Portugal Telecom's board of directors. (Appendix no.10.6)

The latest developments in corporate governance in Portugal are as follows: January 2013 records the approval of the first private initiative corporate governance code; "IPCG" (Instituto Português de Corporate Governance) – the Corporate Governance Code of the Portuguese Corporate Governance Institute. And for the sixth time in the last 12 years, which indicates further instability in corporate governance regulations, the Portuguese Securities Commission "CMVM" (Comissão do Mercado de Valores Mobiliários) updated its mandatory Corporate Governance regulation, Reg. No. 4/2013 on Corporate Governance and published a revised 2013 Corporate Governance Code. Most changes were described as tactical and optimal, other changes lead governance specialists to question the overall applicability of these revisions<sup>8</sup>.

Starting with the positive changes, the importance of "complying and explaining" provisions was better highlighted in the new Regulation. This "comply-or-explain" approach – originally a British solution – is embedded in Portuguese regulations according to the 2010 CMVM Corporate Governance Code. However, the CMVM stated in its annual report of 2012, that in 2011, only "53% of the non-compliance cases to the 'comply or explain' rule, were further explained by the company and accepted by the CMVM." This is a low percentage rate in comparison to other comply-or-explain markets in Europe. It is difficult for shareholders to understand why 47% of Portuguese issuers did not fully conform to the

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<sup>8</sup> "Portuguese Corporate Governance Guidance – For Better or Worse?", Vanessa Iriarte, August 20, 2013.

"comply or explain" requirements— whether due to a failure to explain non-compliance or a failure to simply comply. Perhaps in response to the low levels of compliance, the new Regulation brought the "comply-or-explain" provision to the forefront, outlining an acceptable explanation/level of compliance. Other positive revisions made to the 2013 Corporate Governance Code included changes to remuneration and related party transaction disclosure recommendations, the addition of more defined criteria affecting the independence of non-executive directors (NEDs), and a new recommendation to appoint a lead independent director in the presence of an executive chairman.

Other changes to the Code were not so well received. In the current corporate governance environment – which, mostly, associates an independent board with an effective board – the elimination of a 25% minimum board independence recommendation from the Code is highly unconventional, especially if combined with the removal of the recommendation to establish a nominating committee. As Portugal already recommends one of the lowest board independence thresholds among its European peers, there is a concern regarding what board action the CMVM seeks to promote with this change. In fact this section is considered to contradict the earlier fundamental aim of the code.

Such changes are a serious divergence from recent initiatives elsewhere for corporate governance codes to include specific and increasingly rigorous independence requirements. Instead, the CMVM replaced the 25% independence requirement with a provision that allows boards to determine the appropriate number of independent directors based on the size of a company, its shareholder structure and free-float.

On one hand, the move represented an attempt to shift the corporate governance paradigm towards a more flexible method that valued proportional representation over the enforcement of strict and arbitrary independence requirement. On the other hand, corporate shareholding concentration is high in Portugal, as directors affiliated with controlling shareholders dominate boards. The removal of the independence recommendation, even if subjective, may lead to even lower levels of independence in Portuguese boards.<sup>9</sup>

It is difficult to predict how board independence levels will be explained by Portuguese issuers – if at all – following the new Regulation's emphasis on comply or explain. Theoretically, there is no provision that enforces compliance or explanation and based on the historically low levels of compliance mentioned previously, it is not guaranteed that overall levels of board independence will be enhanced, or that the explanations given by Portuguese issuers will suffice.

### **5.3. Business Ethics within Corporate Governance**

With respect other matters affecting executive management, the next subject of importance is that comes the issue of ethics within corporate governance. Moral hazard comes in many shapes and forms, from negligence and below-par efforts to personal benefits, and from bad investments to accounting and market value manipulations. (Tirole, 2005) "Many observers refer to the matter of "Business Ethics" as an "oxymoron", indicating the contradiction between the two terms combined."<sup>10</sup>

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<sup>9</sup> For instance, only 38.1% of listed companies were in compliance with the previous recommendation regarding independence of the directors. (Centre of Applied Studies – Católica Lisbon SBE, 2012 Corporate Governance in Portugal in 2012 Report on the Degree of Compliance with Corporate Governance Recommendations.

<sup>10</sup> Quote taken from Professor Duarte Pitta Ferraz, business ethics class notes, 2014.



It is difficult to create a unified code of conduct, which is to have a general standard of business practice that can be applied equally to all countries over and above their local customs and social norms.

There are four categories of moral hazard, according to Tirole (2005):

- 1) "Insufficient effort" – otherwise described as negligence. It refers to the allocation of effort and time to each particular assignment.
- 2) "Extravagant Investments" – one of the prime cases observed today where executives engage in "pet" projects of personal benefit, investing largely to the detriment of their shareholders.
- 3) "Entrenchment Strategies" – this is the case when a corporate executive thrives to protect their position at the expense of shareholders. One example is their investment in particular lines that they are good in managing and hence render themselves indispensable to the company. Another example is the manipulation of performance records, such as the manipulation of accounting records and market values and the excessive or insufficient engagement in risky investments also to either preserve a position or gamble in desperation to gain fast good results.
- 4) "Self-dealing" – when managers operate under bad faith with the aim to increase personal benefits from managing the firm, by engaging in a large variety of self-dealing activities that range from mild to outright illegal activities. Their behaviors may range from expenditures on excessive leisure to selecting friends for succession of their role or selecting costly suppliers based on personal relationships up to conducting transactions with affiliated firms they personally own. Recent scandals have involved more focus on self-dealing which is easier to discover than other moral hazards.

In Portugal, the problem of moral hazard stems from the level of dependency of board members and interpersonal relations between executives and the board, such was apparent in the cases of BES and Portugal Telecom among other examples.

In fact, the ethical track record of many organizations is that no ethical policies or procedures have been in place <sup>11</sup>

There are two sides to moral hazard, the more obvious one being managerial misconduct, and the root behind it being the institutional response to this misconduct, which concerns corporate governance, corporate finance and managerial incentive contracts. Several forms of dysfunctional governance have been noted as playing an important role, such as: lack of transparency – when investors and stakeholders are misinformed regarding managerial compensations, and the limited transparency of managerial stock options, or perks outside the control of investors such as the purchase of an expensive private jet, or hiring friends and family which frequently observed the case of European firms. Another form of dysfunctional governance is the increasing amount of total compensation packages of top executives, which have reached extremely high levels over the past years. Again this is a trend that has become more prevalent in European firms. In turn, this leads to an even more difficult dysfunction that of the tenuous link between performance and compensation, i.e. when higher levels of compensation do not go along with performance levels, and when top

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<sup>11</sup> Quote taken from Professor Duarte Pitta Ferraz, business ethics class notes, 2014.

executives receive large compensations for a lackluster or even a bad outcome (Bebchuk & Fried, 2004). This is also a distinctive problem of companies in Portugal.

Finally there is also the ethical issue of, the multipurpose accounting manipulations conducted with the aim of inflating company performance. (Tirole, 2005)

It should be noted that, although many cases of misconduct or inadequate investment and below-par performance have been observed widely across boards of companies in Portugal, there are prime examples to executive members and leaders which have maintained a reputation of morale, integrity and law compliance while investing, internationalizing and expanding their firms. This highlights how values and compliance to stature policies and rules resonate from executives and their management styles differ.

Such examples of business moral integrity and utter independence can be seen in the following in the examples: Sonae led by Belmiro de Azevedo, a Portuguese leader in the areas of Real Estate and Retail and holds significant investments in telecommunications, tourism, venture capital and media. Belmiro was the entrepreneurial founder of Sonae and created an empire, which expanded from Portugal to numerous countries: Spain, Greece, Brazil, Italy, Germany and Turkey. "Sonae built its firm and structure on a basis of meritocracy" in the view of Professor Duarte Pitta Ferraz. The firm is open to diversity, introduces international members to its supervisory board, where the concept of "change-management" is part of its corporate canvas.

Jeronimo Martins (JM) is another example of a prominent Portuguese firm, which could be considered to demonstrate good corporate governance practices, under the direction of Alexandre Soares dos Santos. JM is a Portuguese corporation that operates in consumer goods manufacturing and food distribution. It operates around 2,800 stores in Portugal, Poland, and Colombia. The company recently relocated its headquarters to the Netherlands, due to the fast-changing fiscal system in Portugal, along with the robust tax authorities, which it believed were harming its firm.

Among other Portuguese corporations there are less well known firms and executives such as CIN Corporação Industrial Do Norte led by Antonio Serranha are also noteworthy. CIN a Portuguese company and the Iberian market leader in paint & coating products. The company was established in 1926 and is headquartered in Maia, North of Portugal. CIN is also a member of the Coatings Research Group Inc. (CRGI) since 1990 in Cleveland, USA, a group that tests innovative prime materials, products and technology in the paint industry.<sup>12</sup>

What these three Portuguese companies have in common is an open structure, which means that the Board and executives listen to external expertise in a transparent manner while also expanding the company culture beyond the family-company culture format common in Portugal. They have the same cultural background of other Portuguese companies yet they excel by internationalizing their company culture.

Another important link between these three companies is the applications of standards of moral behavior to business. Corporations continuously attempt to set principles and standards for various

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<sup>12</sup> Excerpts from the interview with Professor Duarte Pitta Ferraz.



business areas by restructuring committees and monitoring levels of compliance. These attempts are in order to help early prevention of possible moral hazards and crisis and also maintain a healthy company in terms of finance, image and stability.

These initiatives led to the "Pacto Global das Nações Unidas" (United Nations Global Pact) a voluntary corporate citizenship initiative, with principles on the four key areas of: environment, anticorruption, welfare workers and global human rights. It sends a strong message to stakeholders and is an organization committed to wherever the company conducts its business. In addition to the United Nations Global Pact, an internal tool widely used by executives is the "Acid Test"; which helps recognize unethical behavior within the corporate governance of a company. This test is a simple investigation on whether the executive or person in question would be embarrassed or uncomfortable, should a particular situation of theirs be published on the first page of a daily newspaper<sup>13</sup> and enforces the decision-making of the individual to act in line with good ethics accordingly.

#### **5.4. Corporate Governance and financial reporting**

Corporate financial reporting is an essential role in modern-day economics. In a business environment filled with bankruptcy news, creditors and investors pay attention to financial reports to distinguish companies experiencing economic distress from those that are profitable. These statements, in line with accounting standards, also help corporate leadership prevent losses resulting from litigation in case of inaccurate reporting. (Góis)

According to the conclusion by Cristina Gonçalves Góis' research article on "Financial Reporting Quality and Corporate Governance": Portuguese institutions have followed closely the main international guidelines relating to the rules of good governance. However the actual implementation of these rules did not occur. This indicates a failure to comply at all, which is in line with results reported by CMVM earlier.

According to (Cohen et al., 2004) one of the most important features of corporate governance is the assurance of the quality of the financial reporting process of institutions. An additional reference by (Sloan, 2001), demonstrates how financial information is the primary source of independent and truthful communication regarding the performance of corporate executives. That said financial reporting is the main source of management influence. This provides another indication on how important both transparency and truthful reporting is.

#### **5.5. Risk aversion in business**

Risk aversion is a fundamental concept in Finance and Economics and it is based on human behavior and is largely regulated by external factors such as the corporate environment. According to the 2014 OECD<sup>14</sup> report, risk taking is "a fundamental driving force" in both business and entrepreneurship, however the cost of risk management failures was still underestimated. The relationship between the concepts of risk taking and corporate governance is that the latter should ensure risks were understood, managed and appropriately communicated. While many companies have started paying

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<sup>13</sup> Arguments and quotes based on Professor Duarte Pitta Ferraz business ethics class notes, 2014.

<sup>14</sup> OECD (2014), *Risk Management and Corporate Governance*, Corporate Governance, OECD Publishing. <http://dx.doi.org/10.1787/9789264208636-en>

more attention to risk management, yet they are focused in the financial sector and on companies that were affected deeply by the crisis. Moreover companies considered risk management to be the responsibility of line managers and company boards started to review their structures, reducing potential incentives for excessive risk-taking.

A few years ago, the Hofstede research center<sup>15</sup> released a study<sup>16</sup> by Geert Hofstede on the risk aversion of countries among other characteristics. At the time of the study Guatemala was the most risk averse and Portugal came as the second most risk averse. Today Guatemala got to third place while Portugal still remains as the second most risk averse country. Portugal's Uncertainty Avoidance Index (UAI) scored 104, while Guatemala scored 101, Germany 65 and Singapore 8 and ranking last on the UAI list.

Hence, while the Portuguese are quite entrepreneurial, they are still very risk-averse. Their entrepreneurial spirit is focused on mostly small businesses and lifestyle, without a defiance of status quo. Very few think with a European or global focus and target millions as opposed to living expenses. This gives an insight on executive behavioral tendencies in Portugal.

### **5.6. Organizational structures**

Organizational structures are the method by which an organization communicates, distributes responsibility and adapts to change. They define how the company's activities are outlined and directed towards the achievement of its goals. They can also be considered as the viewing point through which individuals see their organization and its environment. Organizational culture, also known as corporate culture, is a substantial component of organizational structure and plays a huge role in how companies operate. Eleonore Breukel found through her research<sup>17</sup> that there were two types of cultural orientation: Relationship-oriented versus Task-oriented. In Southern Europe, people identify themselves in groups within familiarity of family and friends with interrelated interests based on trust before business. Whereas in Northwest Europe, where goals are individualistic and trust is established through quality, compliance and financial turnover. Moreover, Southern European countries are sensitive to hierarchy and social status, openly showing unquestionable respect to important people, where a boss is perceived as a father figure and provider while Northwest Europe relies only on the basis of meritocracy.

Looking at Companies in Portugal, companies stem from a family setting which in turn sets unspoken positions of power. Corporate executives exert individualistic management styles, as seen in the example of Ricardo Salgado, president of BES. When looking at the corporate culture in Portugal, it is of familial heritage such as the rest of Southern Europe, with a paternalistic culture where owners are executive officers and management tends to be inherited. Most companies maintain a local culture that stems from the founders, which may also tend to be extremely risk-averse<sup>18</sup>. Micro-management is yet another feature still trending in corporate Portuguese culture, where owners and executives attempt to control every single detail in the firm. This helps better understand the environment in which executives operate.

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<sup>15</sup> [geert-hofstede.com](http://geert-hofstede.com)

<sup>16</sup> [www.clearlycultural.com/geert-hofstede-cultural-dimensions/uncertainty-avoidance-index/](http://www.clearlycultural.com/geert-hofstede-cultural-dimensions/uncertainty-avoidance-index/)

<sup>17</sup> [www.intercultural.nl](http://www.intercultural.nl), Communicating Across Borders Within Europe II, Eleonore Breukel.

<sup>18</sup> According to Chapter 5.5 on Risk Aversion and Business

### **5.7. Role of CEO and his relationship to the corporate structure**

The role of CEO is a key aspect of corporate governance. According to Hermalin & Weisbach (2003), the major conflict of interest in a boardroom is between the CEO and the board of directors. On one side, a CEO has the incentive to win over the board members, to ensure that they maintain their executive position and increase their flow of income. On the other side, directors have the minimal incentives to monitor their CEO and to replace them with reference to levels of underperformance levels. Both researchers also mentioned that the evolution of the board over time is dependent on the nature of the bargaining position of each side. (Góis)

The chief executive officer is considered the most important role in the management of an organization. The definition of chief executive officer according to the Financial Times Lexicon<sup>19</sup> depends on whether a business is a corporation or not, that is, whether it has a board of directors. In an organization that has a board of directors, the "chief executive officer" is the singular organizational position that is primarily responsible to carry out the strategic plans and policies as established by the board of directors. In this case, the chief executive reports to the board of directors. In a form of business that is usually without a board of directors, the "chief executive officer" is the singular organizational position that sets the direction and oversees the operations of an organization.

### **5.8. CEO incentives**

Incentive packages as well as the mandates of the roles of executive officers, play an important role when it comes to management and corporate outcomes.

Incentive packages of corporate executives are usually a sophisticated mix of implicit and explicit incentives, which partially align managerial incentives with the company's interest. Incentives such as bonuses and stock options make executives more sensitive to loss of profit and shareholder value. Besides explicit incentives, more implicit forms such as future career concerns of managers exert a powerful influence, such as the threat of maintaining or losing their position or being put on a tight leash. Psychologists, consultants and other personal officers, discuss broader arrays of managerial incentives, such as intrinsic motivation, fairness, horizontal equity, morale, trust, corporate culture, social responsibility and altruism, self-esteem, job interest and so on. To break down the monetary "explicit" incentives of an executive officer, it is represented in three ways: a salary, bonuses, and stock-based incentives. The salary is the fixed amount that is revised overtime on the basis of performance and other factors, while the bonuses – defined by current profit – and stock-based compensations – based on share values and market data – are the two explicit incentives of the compensation package. (Tirole, 2005)

Moreover, when it comes to "implicit" incentives, managers are intuitively concerned about maintaining their job and position. The Board of Directors has the power to remove the CEO should their performance prove to be poor, and their decision may be supported by the shareholders. Bad or below par performance can also lead to graver situations such as a takeover, a proxy fight, or bankruptcy.

According to Bebchuk & Fried (2003), the design of executive compensations in recent times has been viewed not only as an instrument for addressing agency problems between executives and shareholders but also as part of the agency problem. Executives have substantial influence over their

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<sup>19</sup> Lexicon.ft.com, 28/11/2012

own pay arrangements, and hold an interest in reducing the saliency of the amount of their pay and the extent to which that pay is related to managers' performance.

### **5.9. The Business Judgment Rule and Portuguese Corporate Law**

The Business Judgment Rule is a legal principle developed by the common law, that will not review or hold any liability against executive officers, directors, or other agents of a corporation for losses incurred in corporate transactions under their supervision as long as there is sufficient evidence demonstrating that these transactions were done in "Good Faith" and that the persons involved were disinterested, independent and reasonably diligent.<sup>20</sup>

As directors and executive officers of a corporation are responsible for managing and directing business affairs of their corporation, they often face difficult decision points such as the matter of acquiring other businesses, selling assets, investing in other business areas or issuing stocks and dividends. To help those directors and executives perform their duties without fear, courts in the United States of America, have granted them substantial deference<sup>21</sup> through the business judgment rule.

The origin of the BJR (Business Judgment Rule) was created in the case of *Otis & Co. versus Pennsylvania R. Co.*, 61 F. Supp. 905 (D.C. Pa. 1945)<sup>22</sup>, Otis a stockholder in the Pennsylvania Railroad Co., brought a derivative action against that Company, its officers and directors, and the Pennsylvania, Ohio and Detroit Railroad Co., and its officers and directors. The latter is a wholly owned subsidiary of the Pennsylvania Railroad. In *Otis*, a shareholder's derivative action claimed that corporate directors failed to obtain the best price in the issuance and sale of over \$28,000,000 in securities, by dealing with only one investment house and failing to search for the best possible price in the market, resulting in a loss amounting to half a million US dollars. The federal district court ruled that; although the directors chose the wrong course of action, they acted in good faith and therefore were not liable to the shareholders. The court also reasoned that; "mistakes or errors in the exercise of honest business judgment do not subject officers and directors to liability for negligence in the discharge of their appointed duties."

Following this, the rule was applied to directors' actions when corporations were faced with a hostile takeover. In the case of *Unocal Corp. a major petroleum explorer and marketer versus Mesa Petroleum Co.*, 493 A.2d 946 (Del. Super. 1985) – a landmark decision of the Delaware Supreme Court on corporate defensive tactics against take-over bids - the Delaware Supreme Court advocated the defensive actions taken by a board of directors during a takeover struggle with a minority shareholder. The case was that Mesa Petroleum Company made an offer that would have made it majority shareholder in Unocal Corporation. Within the offer, shareholders who sold their Unocal stock would receive \$54 per share until Mesa acquired the 37 percent it wanted and then, they would receive highly speculative Mesa securities instead of cash for any stock sold beyond that 37 percent. To counteract the takeover bid, Unocal's directors declared that: should Mesa obtain 51 percent of its shares, Unocal would purchase the remaining 49 percent for an exchange of debt securities (securities reflected as debt on the books of the corporation) with an aggregate par or face value of

<sup>20</sup> [www.mondaq.com](http://www.mondaq.com), United States: The Director's Friend: The Business Judgment Rule, Mark S. Adams, Sep. 2012.

<sup>21</sup> *Cede & Co. vs. Technicolor Inc.*, 634 A.2d 345,361 (Del. 1993)

<sup>22</sup> [law.justia.com/cases/federal/district-courts/FSupp/61/905/1607268/](http://law.justia.com/cases/federal/district-courts/FSupp/61/905/1607268/)

\$72 per share, and the offer would not be extended to the 51 percent of stock held by Mesa. Mesa filed suit, accusing the directors of violating their fiduciary duty by excluding Mesa from this exchange. The court decided that the directors' actions were protected by the business judgment rule and proceeded to recognize that in responding to hostile takeover bids, directors of a corporation might face conflicts between their own interests and the interests of the corporation and its shareholders. The court stated that the Unocal directors had reasonable grounds to believe that a danger to the corporation existed due to Mesa's actions and that the defensive actions they took were reasonable in relation to the threat they believed the offer posed.

Criticisms of the rule include: "As protective and linear as the Business Judgment Rule appears to be, it is too abrupt and does not take into account minority shareholders and the responsibility of executives and their actions towards other stakeholders namely employees."<sup>23</sup>

Despite the apparent broad scope of the Business Judgment Rule, however, corporate directors have not always been able to rely on it as an escape from the liability for their actions. In *Smith v. Van Gorkom*, 488 A.2d 858 (Del. 1985), Plaintiffs, Alden Smith and John Gosselin, brought a class action suit against Defendant corporation, Trans Union, and its directors, after the Board approved a merger proposal submitted by the CEO of Trans Union, fellow Defendant Jerome Van Gorkom. The Supreme Court of Delaware held that the directors of a corporation failed to exercise informed business judgment and instead acted in an unacceptably and obvious negligent manner by agreeing to sell the company for only \$55 per share. The court considered evidence indicating that the directors reached their decision to sell based on a 20-minute oral presentation concerning the sale. The court also noted that the directors had received no documentation indicating that the sale price was adequate and had not requested a study to help them determine whether the price was fair. Although the directors were not accused of acting in bad faith, the court stated that the directors' fiduciary duty toward their shareholders required more than merely an absence of bad faith. The directors, according to the court, had an affirmative duty to protect the shareholders by obtaining and reviewing information necessary to help the directors make sound business decisions. By failing to inform themselves they were therefore liable to the shareholders for their bad business decision.

Courts have further held that the business judgment rule will cover the actions of directors only when the directors are disinterested and independent with respect to the action that is at issue. A director is independent when they are "in a position to base their decision on the merits of the issue rather than being governed by extraneous considerations or influences"; conversely, a director is considered to be interested if they appear to be on both sides of a transaction or expect to derive personal financial benefit from it, as opposed to a benefit to be realized by the corporation or all shareholders generally (*Aronson v. Lewis*, 473 A.2d 805 [Del. 1984]). Thus, if one director stands to receive a substantial financial benefit from the issuance of stock nonetheless designed to counteract a takeover threat, the business judgment rule may not apply to the board of directors' actions. Such allegations of: bias, lack of independence, or disinterest must be supported by tangible evidence.

In Portugal the equivalent ruling that would apply to executives' responsibilities towards stakeholders

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<sup>23</sup> Quoted from the interview with Professor Duarte Pitta Ferraz.

would be Chapter VII – Civil Responsibility for Constitution, Administration and Monitoring of Societies of the Code of Commercial Societies in particular Articles number 72. This Article inverts the usual burden of proof. Namely paragraph 1 of the Article clearly states that the executives are responsible for the damage caused by their actions unless proven innocent, which obviously constitutes a reverse onus. This removes a protection that defendants are normally entitled to. The legislator deliberately left executive more vulnerable.

Another significant difference to the BJR is that, unlike this Rule, Portuguese Law does not define any specific areas, where the executives are presumed innocent. Remember as we saw above that decisions made by executives under certain economic rationale were less liable of prosecution, regardless of damage. Negligence and personal interest were critical for prosecution under the BJR. Under Portuguese Law, given the lack of definition on the areas of responsibility, executives are more exposed to prosecution. For instance, the mere economic rationale could be questioned in court.

One may wonder then why with such a lower level of lenience there are so few lawsuits in Portugal. The plausible explanation for this would lie on the rigidity and ineffectiveness of the judicial system tied to the fact that the courts and judges are ill-equipped to deal with such cases.

## **6. Data sources and methods used to collect data**

The methodology used in this study was a qualitative one, involving the study of the case of BES Banco Espírito Santo and PT Portugal Telecom, in addition to interviews with academic and executive professionals.

### **6.1. Interviews**

Interviews were conducted with the following:

#### Academic Professionals

- Professor Duarte Pitta Ferraz (Board Director and Professor) (Appendix no. 11.3)

Questions for this segment were targeted towards the scholarly understanding of Corporate Governance, along with observational inquiries upon the study of the performance of Portuguese firms. The interview session with Professor Duarte lasted 1:00 hour and was recorded, with a detailed written report.

#### Business Executives:

- Mr. Carlos de Sousa Duarte, business owner in Porto. (Appendix no. 11.4)
- Mr. Rui Maximino, COO of Millennium Bank. (Appendix no. 11.2)

Questions for this segment were targeted towards their application of corporate governance processes, along with inquiries on their levels of control, motives and forecasted plans. The interview with Mr. Carlos Duarte lasted 40 minutes with a written report. As for the interview with Rui Maximino, COO of Millennium BCP, the interview lasted 1 hour and 30 minutes and detailed important feedback on the way financial institutions are regulated and are managing the current economic landscape.

### **6.2. Analysis of the cases of Banco Espírito Santo and Portugal Telecom:**

Regarding the cases of BES and PT, this study involved a brief analysis of the history of both companies along with questioning staff members at PT, minor stakeholders at BES and a survey of general knowledge regarding events. Further monitoring of news coverage along with a detailed



review of annual reports for both companies provided additional insights. The purpose was to understand how corporate governance, corporate law and executive management played a role in the downfall of two historical prominent firms in Portugal and what steps could be taken to attempt the prevention of re-occurrence.

Banco Espírito Santo is a banking empire whose history runs as deep in Portugal as the Rockefellers in the United States. The recent Portuguese banking crisis developed as a result of the leaky surroundings of Banco Espírito Santo (BES) with Espírito Santo International (ESI), its conglomerate owner. Since the unfolding of the disastrous event that started around the end of year 2013, evidence had been pointing to grave misconduct and illicit funding transfers to its troubled parent. The ongoing history highlighted ethical issues arising from the agency problem between banks and depositors creating moral hazard and adverse selection. At the same time, BES led to questioning the limitations of regulators in ensuring transparency in the sector.

In the banking industry, the power of Ricardo Salgado as chief executive and member of the boards was evident in the Espírito Santo Group to a point where he was nicknamed "DDT" for the Portuguese acronym of the expression "Owner of Everything". Up until the first leakage published by the Wall Street Journal of ESI selling over 6 billion Euros of debt to its investment funds back in 2011, and that it valued its shareholding in BES at four times its market value at the time. Meanwhile, the government of Angola issued a guarantee of 4.2 billion Euros to BES Angola at the discreet command of Bank de Portugal (BdP). By May 2014, KPMG reported irregularities at ESI, after conducting a special limited purpose review by request from Bank de Portugal.

ESFG – Espírito Santo Financial Group – further reveals that ESI had serious accounting misdemeanors, including omitted debt and overvalued assets, while BES CEO Ricardo Espírito Santo Salgado denies – until today – any knowledge of ESI's actions. In June 2014, this was compounded by media revelations of financial trouble at BES Angola, which finally pressured the resignation of Salgado, and a Luxembourg justice probe on Espírito Santo holding companies.

By July 2014, both Moody's and Standard & Poor's had downgraded BES despite assurance from management that it can withstand losses from its parent company. Vitor Bento was appointed the new CEO of BES, Ricardo Salgado was detained for questioning over alleged fraud, money-laundering and falsifying documents. At the end of that month, BES reported a record-breaking 3.6 billion Euros in losses for the first half of 2014 resulting from provisions made to cover for 1.2 billion Euros of exposure in the troubled Espírito Santo group as well as losses on loans made by the Angolan unit. In Aug 2014, BdP announced that it would invest 4.9 billion Euros to spin-off the healthy assets while isolating toxic assets in a bad bank, which led to the creation of Novo Banco.

The largest downfall of this tragedy was the alliance between BES and Portugal Telecom (PT) and the impact BES had as a minority shareholder of only 10% at PT. The case started since the prospective merge back in October 2013, between PT and Oi – Brazil's largest Telecom Company – giving PT a much larger market with over 10 million clients. When BES fell apart, so did PT (domino effect) along with their credibility. It led PT to deal with the default of 897 million euros in commercial paper of

Rioforte<sup>24</sup>, which forced to renegotiate the terms of merger for PT with OI and destroyed the future of PT with a cancellation of the merger and a devaluation of the company. French company Altice<sup>25</sup> acquired PT earlier in 2015.

## **7. Data treatment and analysis**

When it comes to corporate law in Portugal, academics and management enthusiasts argue the efficiency and applicability of the rules governing companies. The judicial system in Portugal is often<sup>26</sup> described as a rigid system that does not function as intended. An ineffective judicial system quickly becomes a hindrance for businesses to follow their mandates, as it hurts investment and growth. Executives will then have the tendency to going about is through bypassing the judiciary system and the law, with the aim for pursuing corporate and personal objectives. This may create an adverse selection of executives that links success to dodgy shortcuts in legal or institutional trajectories.

Furthermore concerns came as a result of how it is increasingly difficult for shareholders to sue corporate executives post recent managerial mishaps in Portugal, who in turn are protected by the law and by their own positions of power. Lawsuits take a longtime in courts, effectively causing more damage.

Another matter raising concern is the issue of tax implications on CEOs, where in Portugal, when legal authorities hold suspicion that a company owes tax debt that remains unpaid, they immediately go after seizing the corporate executives' own personal assets.

It seems so that this system – and most of all the behavior of people relatively to it – creates deep ambivalence. Such ambivalence is present because the rules can be appropriate but rigid and with low margin for excuses, while at the same time deviation is not sufficiently stopped and punished. It is then critical to assess why does deviation happen and also why is it not spotted timely. One can suspect that there is both a lack of regulation and a level of difficulty to avoid corruption – or at least some form of shirking.

In face of this, we need to assess if recent adjustments have shown improvement, or are prone to bring it, as well as identify what more could be done.

The recent spread relocation of headquarters of Portuguese companies to foreign states can show that there is attrition against the current state of the system, and a push for it to adapt. An example can be seen in the relocation of Jeronimo Martins, a Portuguese company that relocated its headquarters to the Netherlands, but there are plenty of other recent cases, that raised less attention.

### **7.1. Interview findings**

The interviews highlighted the following:

- 1- There was no direct relation made between corporate law in Portugal and the actions and behaviors of executives.
- 2- The Business Judgment Rule was viewed as too simple and lenient.

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<sup>24</sup> Rioforte Investments, Holding Controlling all of Grupo Espírito Santo's Non-Financial Assets

<sup>25</sup> Multinational cable and telecom company

<sup>26</sup> See the World Justice Project country profile in Portugal  
([http://worldjusticeproject.org/sites/default/files/files/country\\_profiles.pdf](http://worldjusticeproject.org/sites/default/files/files/country_profiles.pdf).)



- 3- There was general consensus on the bureaucratic nature of courts and their need for better preparation.
- 4- There was no sufficient monitoring of any kind over executive management at corporations and disapproval over supervision committees.
- 5- Corruption is deeply embedded in Portuguese culture; hence it is rare for powerful individuals to be held accountable. The year of 2014 is a true statement of change.
- 6- Both executive and non-executive board members had very lenient mandates towards the validity and renewal of their positions, giving way and sufficient power to create personal relationships and profit.

#### **7.2. The analysis on the cases of BES and PT is as follows:**

Banco Espírito Santo - Regarding the case of BES - according to the Financial Times report, April 17, 2015, stated that the former chief executive of BES, Ricardo Espírito Santo Salgado, was potentially involved in a deliberate plan of manipulating accounts of Espírito Santo international, leading to an estimated 10 Billion Euros of losses for investors. Accusations to which Mr. Salgado's own words were "I never instructed anyone to conceal the Group Espírito Santo's (GES) debts". A post in Portuguese media news further confirmed this, where they announced the results of the preliminary report by the Parliamentary Commission of Inquiry (CPI) on the Management of Banco Espírito Santo, concluding that Ricardo Salgado was surely aware of the fraud in the bank accounts since 2008. "The systematic and reoccurrence of passive concealed practices since 2008, with translations of net income or equity not overly penalized, hardly conforms to possible mere accounting errors, and should be timely and promptly corrected definitively", Pedro Manuel Saraiva, MP, member of the CPI, April 2015.

Furthermore, when analyzing the management style and level of power and control in BES, the abovementioned deputy<sup>27</sup> added that "given the prevailing management style in Group Espírito Santo, the centralization of knowledge and responsibility around the figure of Ricardo Salgado, particularly in treasury management, along with José Castella<sup>28</sup>, lead to the belief that Ricardo Salgado has been involved in making intended manipulated decisions on ESI's accounts since 2008, which would also apply, although perhaps with varying degrees to the case of José Castella as well."

Regarding structure and governance models, GES chose to evolve to create a complex web of companies with operations in multiple countries, including various types of vehicle bodies, and organizations based in tax havens.

"Many of these weaknesses, in terms of leadership and GES' governance model began to be questioned since the company went through a generational renewal in the composition of its Superior Council in 2011, after the joining of Pedro Mosqueira do Amaral<sup>29</sup> and José Maria Ricciardi<sup>30</sup>. " Regarding the supervisory committees, there is a common thread identified, a constant resistance, inertia and delay by both GES and BES Group in the implementation of certain recommendations or charges by the supervisory authorities."

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<sup>27</sup> Deputy Pedro Manuel Saraiva is a member of PSD – Social Democratic Party, a party in the ruling coalition in Portugal.

<sup>28</sup> José Castella served as controller of Espírito Santo Financial Group SA since 2002.

<sup>29</sup> Senior board member of the Espírito Santo Group since 2008

<sup>30</sup> Chief Executive Officer of BESI since 2003

During the inquiry meeting at the Portuguese parliament, Ricardo Salgado denied hiding or giving any instructions to hide information about the financial losses. He also denied that BES was to blame for the impact that its fall had, namely on PT. Furthermore, he accused the Bank of Portugal of not giving the bank enough time to recover, and even denied the bankruptcy of the bank. [Portuguese Parliament Inquiry Commission audits, Relatório Preliminar de Inquérito Nov/2014 to Feb/2015]

Portugal Telecom - Moving onto the case of PT, "The analysis of the ESI financing operations and Rioforte by PT points out that the implementation involved various accountable individuals, of which: Henrique Granadeiro<sup>31</sup>, Zeinal Bava, Luís Pacheco de Melo<sup>32</sup>, Carlos Cruz<sup>33</sup>, Ricardo Salgado, Amílcar Moraes Pires<sup>34</sup> and Joaquim Goes<sup>35</sup>."

Zeinal Bava during the inquiry meeting at the Portuguese Parliament basically stated repeatedly to the majority of questions that he did not remember or did not know about the information of his own company. [Portuguese Parliament Inquiry Commission audits, Nov/2014 to Feb/2015] Bava also affirmed during the inquiry that he did not reclaim any bonuses from PT after leaving the company. He added that bonuses attributed to PT Portugal were done with rigorous criteria and were evaluated by both a salary committee and a performance evaluation committee. [Agência Lusa, 26/Feb/2015]

In fact, in 2014 PT SGPS paid the highest bonuses amongst all companies present on the Portuguese Stock Exchange market, during the worst year for the company's performance. A total of 14.3M€ were paid that year, in salaries, past bonuses and compensations to its managers and executives. Yet, the company cancelled the payment of another 15.3M€ to three ex-executives, due to their involvement in the Rioforte investment. This bonus cancellation is according to the law that allows the deferment of up to 50% of bonuses for a maximum of three years. [Observador, Feb/2015]

An average total of 117M€ was paid by PT to its management team since 2004. Meanwhile, during the last decade, PT had a devaluation of 87% and often its employees had salary cuts.

CMVM forced PT to complement the 2013 PT report with missing information. At the behest of the Portuguese Securities Market Commission (CMVM), PT can also deal with a case of offense regarding omitting information.

Looking at individual remuneration of executives at PT, Zeinal Bava, during his position as CEO of Oi and PT in Portugal, earned in 2013 a total of slightly over a million euros where around 40% of it was a fixed salary. The remaining 60% correspond to a variable remuneration from 2012 results. Bava, on the 4th of June 2013 ceased administrative functions of the PT SGPS, and had received more than 1.2 million euros in 2012, as CEO of Portugal Telecom. Those remunerations were publically announced in the Portuguese media<sup>36</sup>. The type of compensations and the values involved here reflect little of the performance of PT in those years, which was not that outstanding. These levels of payments and practices seem to confirm the notion that there is very little link between pay of

<sup>31</sup> Chief Executive Office and Director of Board at Portugal Telecom, renounced positions in August, 2014.

<sup>32</sup> Financial Administrator of Portugal Telecom

<sup>33</sup> Manager of the Financial Department of Portugal Telecom SGPS, S.A. Appointed 2001

<sup>34</sup> Successor of Ricardo Salgado in BES.

<sup>35</sup> Administrative responsible of risk at BES

<sup>36</sup> See Jornal de Negócios, 20<sup>th</sup> of February of 2014.

executives and company performance in the largest publicly traded firms in the country. (See Costa, 2015)

As PricewaterhouseCoopers (PWC) stated on its analysis dated January 2015 of the PT – GES relationship, the subscription of commercial paper issued by GES was always performed according to two internal rules that dismissed approval or prior appraisal by the Board of Directors, by the Executive Committee or by the Audit Committee. Hence, those subscriptions were never the object of such approval or of prior appraisal.

One of the orders was created on December 1<sup>st</sup>, 2004 – Service Order 2504 – that stipulates that the delegation of powers conferred on the Executive Committee by the Board of Directors, to individually appointed members. On Section 206 of Annex II of this Service Order, the Chief Executive Officer, the Executive Director responsible for finance and the Director of Corporate Finance have the power to make applications of cash surplus, through any of the legally permitted forms, by periods not exceeding 180 days, and without value limit.

The other order was created on February 23<sup>th</sup>, 2011 – Administrative Order 111 – which currently is still in effect and which maintains an exemption from the need for approval by the Board and prior approval by of the Audit Committee, for financial investments with related parties, if carried out under market conditions.

Portugal Telecom (PT) may have to pay a fine of up to five million euros for violations of the Securities Code related to investment in applications Espírito Santo Group (GES), despite the fact that they were following internal rulings closely. One of the potential breaches of the operator is related to the failure of publicly disclosing the investment in Rioforte in the report and 2013 accounts.

José Alves, president of PwC explained that the initial understanding of PwC is that this matter would be included in the independent audit requested by the company. But after a "great discussion" with the customer, PT, references were taken from the individual and collective responsibilities of the governing bodies the legal level. This statement has just been confirmed by itself CMVM, in a statement in which insists operator has to provide more information on the sale of PT Portugal and the possible consequence of the end of the merger with Oi. In this note the CMVM stresses that have not cleared the knowledge and responsibilities of the Brazilian company in the decision on investments in Rioforte.

While most of the previous accusations would likely not pass under the Business Judgment Rule, one case at PT could be an example of what could possibly be acceptable under the Business Judgment Rule:

### **7.3. The case of the data center in Covilhã:**

Following the recent PT debacle it is expected that all recent decisions by the Board will be thoroughly scrutinized. As such, to illustrate the differences in corporate law between the BJR and the Portuguese setting, one the largest investments by PT was selected, namely the 90 million large investment in the data center of Covilhã. While in the Rioforte example described in the previous section, both settings would likely operate similarly prosecuting involved management; this study claims that in the case of the data center the judicial outcome would likely be different under the BJR and under Portuguese corporate law.

In 2011, PT had planned to increase and continue investing in technology and innovation, in response to the global economic slowdown forecasted to continue throughout 2012. It was the year that PT developed its investment in cloud computing, through the construction of a data center in Covilhã, in an attempt to innovate, anticipate future trends and diversify services. The Board believed that this investment, which cost around 90 million Euros, would substantially improve the efficiency of data transmissions, allowing significant cost reduction and service quality.

The location of Covilhã was chosen among 25 other locations for the following reasons: The data center was designed to use a free cooling system by utilizing the cold air in Covilhã where it snows in winter, in technical terms: they only needed 0.25W of AVAC per each Watt in equipment, when the industry average was 0.75 or 1W. Covilhã also provided huge job opportunities. Wages and employment turnover there were much lower than in big cities. Covilhã is also one of the places in Portugal with the lowest earthquake risk and situated very close to Spain, which can be important for the exporting of services. Finally, PT was creating a new line of business, shifting from pure telecom to IT and cloud services.

The decision to build this data center, which PT called a "Technological transformation cycle" involved an investment of over 20% of capital expenditure, where the typical investment expenditure lies between 10-12%.

However one of the concerns that were raised during the inauguration of the center was by PT's architectural technical officer, Jose Salas Pires, who stated that he was disturbed about a legislation that could be enacted as an outcome of Edward Snowden leaks. (IBTimes UK, Sep. 2013) Pires said, "Local laws will tighten countries on themselves, and for me it's a problem, as Portugal is too tiny for my project. We need to go global."

Moreover, many questions are being raised as to the sustainability and long-term plan of this data center. A study by Manuel Patrão de Matos Lopes (2012) tackled the reality of variances in Portugal's socio-economic development. Explaining how the problem persisted in various regions of the country, including the Interior, the victim of unequal progress since the 1980s and the downfall of the textile industry. The attraction of investments is usually seen as a priority and an essential element in the economic development of a region, which is also the reason for investments made in a region like Covilhã. The study by Manuel Patrão is supported by the studies of Michael E. Porter (1947 and 1990), and explores the case of PT's large investment to set up the data center in Covilhã, seeking to identify and trace the path to how a city in the interior of Portugal can attract investment and enjoy full progress. For the success of such a project, Covilhã has to differentiate and explore its own potential and focus on creating differentiation and regional competitiveness.

Thus, for a country town to attract such an investment it should have autonomy of the local government and strong institutions; utilize the strengths of its geographical location and its natural resources; focus on innovation, technology and human capital and establish long-term strategies. The question remains if Covilhã was the appropriate location to invest in.

Under the Business Judgment rule, the case of Covilhã would not be questioned as part of an investigation on PT's activities, whereas in Portugal, if a meticulous investigation were to go through all projects of PT, the Covilhã decision would require precise justification for such a substantial

investment under the reversal of the burden of proof. As seen above, the data center follows an economic/corporate rationale that does not protect the PT executives under Portuguese corporate law (see discussion on Article 72 of the Portuguese Code of Commercial Societies) and could be conceivably part of a lawsuit against the executives that made the decision.

## **8. Presentation of conclusions and implications of the work; discussion of main limitations of study**

The final report of the inquiry commission on BES and its holding company GES stated that there are omissions of debt and that such omissions would hardly be mere accounting errors. [Sol, 29/April, 2015] Moreover, it was concluded that Ricardo Salgado was involved in the decision of intentionally manipulating the account of ESI since 2008. [Económico, 29/April/2015]

Following these findings, the question that will now arise is whether the Portuguese system will be able to justly and efficiently condemn such behaviors, should they prove to be non-conformant.

Meanwhile, the domino effect of the downfall of reputable firms and institutions in Portugal has not come to an end yet. There is already speculation on the media that another Portuguese bank is in risk of falling: Montepio Geral<sup>37</sup>, namely due to the exposure it had to BES.

The main goal of this study is to assess the Corporate Governance structure and legal framework of Portugal – in the sense of their responsibility for malignant cases or just lack of control on exceptional misbehaviors, and such impact on general Portuguese executives. And on this matter – although there may be some indication that the system needs to be adjusted – there was no proof that the system is to blame. Nevertheless, there are failures in the control of malignant situations and their adequate punishment and obviously the system was not solid enough to prevent the cases from happening.

Eventually, companies themselves have to guarantee that some powers are not allocated to only one person. As this study claims, this is not necessarily a failure on behalf of CG, but rather a consequence of corporate culture embedded in Portuguese organizational structures.

It is also striking that most of the decisions leading to the recent mishaps were done within legal, corporate or specific bylaws, and all this under the supervision of several regulators. In this study we explain all of this by the gray areas that are created beyond these institutional settings, areas where only executives with certain characteristics<sup>38</sup> operate comfortably. The example described in this study of the "comply or explain" rule and its application in Portugal is clear illustration of this and it loudly leaves open the question of accountability of regulators and similar institutions.

One other strong example of this is the case of PT, having subscribed commercial paper by GES without approval nor appraisal by the Board of Directors, neither by the Executive Committee nor by the Audit Committee, as internal company rules and bylaws mandate. This absence of approval – intentional or not – might be more hazardous than having a lighter system, as on these extreme cases it turns to be impossible to have any accountability for actions.

Ultimately, this study is intended to raise the necessary questions as to how can the judicial system enhance the efficiency of companies and corporate executives at work, how can it encourage risk

<sup>37</sup> <http://pt.blastingnews.com/opiniao/2015/05/montepio-geral-situacao-precario-ensombra-banca-portuguesa-00384933.html>

<sup>38</sup> See Zeinal Bava's hearing at the Portuguese Parliament.

taking, facilitate law abidance and at the same moment effectively prevent and discourage unlawful behavior.

It would be interesting to study in the future how this system judges recent cases of deviation and solves them – either by introducing changes to prevent similar cases, or by punishing them so showing that they were not accepted in this system.

The limitations of this study are time and access to direct information from executives and law professionals. Also the fact that the study addresses ongoing cases as illustrations for the rationale inherent in it was a severe limitation, given the reliability of some of the available information.

In a nutshell, this study fundamentally raises the question of what good is it to have a more rigorous corporate judicial setting if its application is ineffective. The system itself in Portugal seems to debate the same question or else the corporate governance recommendations and rules would not have changed 6 times in the course of the last 12 years only to end in the worst corporate governance scandals ever experienced in the country.

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## **11. Appendices**

### **11.1. The Portuguese Corporate Governance code by the IPCG – The Portuguese Institute of Corporate Governance, Bylaws of the code are comprised of the following 25 articles:**

#### **Chapter 1 – Denomination, Duration and Headquarters:**

Article 1: The Portuguese Institute of "Corporate Governance", governed by statute, is an Association of private law, non-profit, incorporated for an indefinite period.

Article 2: 1) Institute headquarters are located in Lisbon, at Avenida da Liberdade, no. 196, 6<sup>th</sup> floor, in municipality of Lisbon. 2) The seat can be changed to any other location in national territory by resolution of the General Assembly. 3) The office may establish branches in any location in the country by a board decision, which will establish the respective boundaries, assignments, administrative structure and powers.

#### **Chapter 2 – Subject:**

Article 3: The research and dissemination of Corporate Governance principles and the development of all activities suitable to this purpose, of which: 1) A forum for all matters relating to Corporate Governance, covering the development of good management practices of legal individuals, among other subjects. 2) The issuance of professional qualifications for shareholders, partners, members of the board of directors, managers, administrators, auditors, tax advisors and other. 3) Foster competent performance within the activities of the board of directors, the tax advisory and other. 4) Train qualified professionals for positions on boards of directors, tax advisory and other. 5) Disclose and discuss concepts of Corporate Governance, monitor and participate in national and international institutions regarding the subject of the institute and foreign counterparts. 6) Ensure that legal individuals adopt the necessary government guidelines, management transparency, accountability and fairness. 7) Develop technical material on Corporate Governance for publications. 8) Conduct courses, seminars and congresses on Corporate Governance. 9) Act as interlocutor with national and international bodies, professional bodies and institutes of class. 10) Setup national and international community standards in particular.

#### **Chapter 3 – Associates:**

Article 4: 1) Founding members are the entities and persons that grant the public deed of the constitution of the institute. 2) Founding members are members on the list annexed to these statutes.

Article 5: 1) Associated with any legal individuals governed by public or private nature, which are admitted by the Board on the proposal from an associate. 2) Associated with any person admitted by the board, on the proposal of a member meeting one of the following requirements: a. A current or previous member of less than 3 years of an administrative, advisory or oversight of a legal entity, or exercising an equivalent position. b. A recognized scholar or expert in matters of Corporate Governance. c. A partner or shareholder of a civil or commercial company or an associate of an association.

3) Request for direction associated with the category of honorary associate – a person who, irrespective of having met the requirements in the preceding paragraph, was distinguished in the

performance of their duties as a member of a social body or legal entity or in the investigation of legal or economic matters concerning the continuity of businesses and commercial companies, and in turn would be exempt from payment of quota. 4) The associate – a legal person – appoints representatives and may at any time change the statement. 5) An associate can be awarded the title of "Sponsor" with the acceptance to pay a higher quota or the provision – permanently or temporarily – of financial collaboration at the institute.

Article 6: 1) Associated rights, internal regulations, the law and other tasks of these statutes: a. Participate and vote in the General Assembly; b. Can be appointed to any office in the body of the institute; c. Are part of committees or working groups as established by the Board; d. Participate in courses, conferences, seminars and other events promoted by the Institute, under conditions established by the Board; e. Make proposals and recommendations for the development and improvement of the activities of the Institute; f. Resign at any given time.

2) Duties of Associates: a. Efforts for the development of the Institute and the dissemination of the principles of "Corporate Governance"; b. Abide by the decisions issued by competent arms of the legal office; c. Protect the good image of the Institute; d. Contribute – through the timely payment of quotas – to the costs of the institute.

Article 7: 1) The Board sets the quotas of associates. 2) Quotas differ depending on the case of a civil or legal person.

Article 8: Any member may be excluded from the Institute, by resolution of the Board, in case of a serious or recurrent failure to fulfill their duties.

#### **Chapter 4 – Bodies of the Association**

Article 9: 1) The Institute's bodies are: the General Assembly, the Board, the General Council and the Audit Committee. 2) By resolution of the Board, an Advisory Board may be created for an ongoing basis, in addition to special committees for the development of specific activities of temporary nature. 3) The mandates of the bodies of the Institute have a time frame of three years.

#### **Section I: - General Assembly**

Article 10: 1) The Board of the general assembly consists of the Chairman and the Secretary. 2) In case of impediment, an associate – who is not a member of directors - replaces the Chairman, and the associated Assembly itself replaces the Secretary.

Article 11: 1) The General Assembly shall meet whenever convened by the General Council, at the request of the Supervisory Board or a group of associates with a minimum of one fifth of the votes. 2) The meeting is issued by a notice addressed to each associate and issued with a 15-day notice, accompanied by the indication of the day, time, place and agenda of the meeting. 3) The General Assembly must meet once a year, within three months following the end of the fiscal year, in order to assess the management report and the report of the accounts for the previous financial year, including other listed matters in the agenda. 4) The annual general meeting, stated in the preceding paragraph, still precedes with the election of members of the General Council and of members the Fiscal Council, when their mandate ceases. 5) A member of the council can be represented by a board member or associate, by formal request to the Chairman of the Board. Or in the absence of such, can be represented by the Chairman of the Board himself.

Article 12: 1) The General Assembly may make any resolution, on first call, without the presence of at least half of its members. 2) If after 30 minutes of the appointed time for the first meeting there is no incorporating board, the general meeting shall meet immediately on second call, whatever the number of members present. 3) The resolutions on amendments to the statutes of the Institute require a vote of three-quarters of the members present. 4) The deliberations about the transformation or dissolution of the Institute require a favorable vote of three quarters of the total number of members.

## **Section II: - The Directorate**

Article 13: 1) The Board is composed of an odd number of members, between three and nine, elected by the General Council, with permission for reelection. 2) Board members may be civil or legal persons, associates or non-associates. 3) Elected legal individuals submit to the provisions of article 5, paragraph 2. 4) Board members appoint, amongst them, a President and two Vice Presidents, who replace the President on his absences or impediments. 5) In the case of an impediment whether definite or re-occurring, the remaining members of the board shall appoint a replacing President, who shall exercise the allocated functions until the expiry of the mandate.

Article 14: 1) Associated directors do not receive any remuneration for office duties. 2) The President can be assigned remuneration by the General Assembly for the professional execution of this post.

Article 15: 1) The Board meets regularly every two months, or whenever convened by the Chairman, either on his initiative or at the request of two directors, the General Council or of the Supervisory Board. 2) The meetings of the Board shall be convened by letter or fax, at least five days, with an indication of the agenda; the irregularity resulting from the lack of notice or of the full indication of the agenda is remedied if all directors are present. 3) The Board can only meet with the presence of a majority of its members, being however required the presence of the President or one of the Vice-Presidents. 4) Meetings are by the director for such act as chosen by the Board, or by a Senior Executive of the Institute. 5) Decisions are taken by a majority of the votes and who preside over, beyond its, casting vote.

Article 16: 1) The Board is competent to practice all acts under the law or the statutes, which are not exclusively assigned to the General Assembly, the General Council or to the Supervisory Board. 2) In addition to other matters provided for in the law or the statutes, the Board, namely: Manages the Office and guides all its activities; Represents the Institute, both inside and outside the court; Approves internal regulations of the Institute; Submits proposals to the General Council and to the General Assembly and gives an opinion; Draws up annually, the Institute's management report and the accounts of the fiscal year; Approves contracts, irrespective of nature, between the Institute and third parties; Decides on the creation, extinction and functioning of the Advisory Board and committees for the study and pursuit of the principles of Corporate Governance; Sets the value of the annual quotas of members; Decides on the opening of branches; Resolves the acquisition, alienation, encumbrance, lease or rental of real estate, on acceptance of donations and endowments, as well as the establishment of rules and regulations concerning possessions. 3) The Board may delegate one or more of the Directors responsible for engaging in certain acts or categories of acts.

Article 17: The Office is bound by the following signatures: The Chairman of the Board, or the substitution by one of the Vice-Presidents; Two directors; A director, in the use of delegations of

powers given by the Directorate; One or more prosecutors, under the general terms of law.

### **Section III: - The General Council**

Article 18: 1) The General Council is composed of an odd number of members between 9 and 21 members, elected by the General Assembly, with reelection. If the General Assembly did not elect the maximum number of members, the General Council itself can appoint new members to that limit, subject to ratification at the first general meeting following. 2) The General Council must be composed mostly of legal members. 3) Collective members post election, communicate to the President of the Council communicates General, the name of the individual person conforming to the statutes they represent and this communication should be updated whenever necessary. 4) The General Council appoints the President from among its members. 5) A director cannot be designated member of the General Council. 6) In case of impediment, of termination or takeover by a member of the General Council, the remaining incorporate a substitute, who shall exercise functions during the period for which the General Council was elected.

Article 19: The members of the General Council are not remunerated, with an exception to members of the General Assembly.

Article 20: 1) The Council meets at least once every six months or whenever necessary or convened by its Chairman, by a majority of its members or by the majority of the members of the General Assembly. 2) The meetings of the General Council shall be convened by letter or fax, at least five days, with an indication of the agenda; the irregularity resulting from the lack of notice or of the full indication of the agenda is remedied if all members are present. 3) The decisions of the General Council shall be taken by a majority of votes, in addition to its Chairman, have casting vote.

Article 21: 1) The General Council is responsible to: Appoint the Board and represent the Institute in its relationship with the Board; oversee the activities of the Board;

Ensure that the Institute's objectives are achieved; Approve the programmed objectives of the Institute; Convene meetings of the General Assembly and of the Board. 2) The General Council may appoint – from among its members – Committees that prepare its deliberations and oversee their implementation.

### **Section IV: - The Supervisory Board**

Article 22: 1) The Audit Committee consists of three members, of which two of them will be associates, each of which shall perform the functions of President and Vice-President, and statutory auditor, elected at the general meeting. 2) An elected member can be an alternate member of the associate members. 3) Exceptionally and for the 2009, the term of Office of the members of the Supervisory Board elected for 2009, ends 31 December of that year.

Article 23: 1) The duties and responsibilities of the Supervisory Board, in particular, are to ensure compliance with legal and statutory provisions, give an opinion on the management report, balance sheet and annual accounts and on ordinary budgets and amending budgets and decide on matters to which the General Assembly, the General Council or the Directorate decide to hear. 2) The Audit Committee shall meet whenever necessary for the practice of acts of its competence and shall act by majority vote.

### **Chapter 5 – Revenue and Fiscal Year**

Article 24: 1) Constitute the Institute's format: The quotas of its members; Revenue from the participation of associates or other persons in congresses, courses, seminars and other initiatives of the Institute; Revenue from publications or other activities of the Institute; contributions by sponsors; Donations, bequests or grants; Other revenue, legally allowed. 2) The social year coincides with the civilian.

#### **Chapter 6 – Dissolution and Liquidation**

Article 25: 1) Extinguishing the Institute, the liquidation of its assets. 2) The Board, in Office at the time of dissolution, assumes the duties of liquidator, unless the general meeting appoints, for that purpose, one or more persons. 3) The General Assembly shall determine the fate of the remaining assets, after satisfied the liability.

#### **11.2. Interview with Rui Maximino – COO Millenium BCP**

JK: "My thesis is on whether a particular corporate governance structure or legal framework would affect the strategic decision-making and risk-taking tendency of Corporate Executives. The topic is covering areas of corporate governance, corporate law, ethics, tax law, and other areas such as culture, CEO profile etc."

**JK: As Executive Board member and COO at Millennium BCP (Largest private bank in the country), what is the trend observed today among corporate executives towards risk taking: are they taking healthy risks and making investments or are they rather risk-adverse? Why**

RM: I don't believe that strict governance rules imposed by law ethics or industry standards are a problem for management it's the opposite. Meaning these kind of frameworks have the objective to make sure that all the interests are aligned. Meaning the interests of all stakeholders, managers and company. I don't believe the main driver for a decision should be the shareholders consensus. The duty goes well beyond shareholder.

**JK: Do you think the judiciary system in Portugal encourages or discourages risk-taking and investment decisions by CEOs?**

**JK: Have you heard of the Business Judgment rule in Delaware? Would you find it efficient if applied in Portugal?**

RM: I have vague knowledge of the Business Judgment rule, but I am for strict systems and I find this rule too lenient.

**JK: Are there any restraining laws that hinder the decision making of an executive?**

It is not a matter of law. We have all the regulators and laws needed. The problem is the actors. And I don't believe the courts in Portugal are demanding.

**JK: What do you think of the process in Portuguese courts?**

Yes this is a problem. Example we see very few managers convicted. Our legal system is very old and bureaucratic; the judges don't have the proper knowledge to understand economic crime properly. They don't understand the process. But I still conclude this as not a problem of law, but a problem of process.

**JK: Are there any mandates to executive and non-executive director positions in Millennium?  
(Time frame for keeping certain positions in board)**

Yes of course and it applies to me as a board member in affiliated companies. The usual corporate governance in any top tier company has mandates.

I don't believe in time frame mandates. My view is that renovation is positive in both executive and non-executive members. This issue is debatable. You should renovate at least some of the critical functions, of executives and supervisory functions. Usually the NEDs here are renovated more often than executives, as they regulate and monitor. By rule I believe shareholders should impose a renovation option. In the end, it all depends on circumstances. You shouldn't allow the creation of situations where you are there for too long and do not do your job properly. I believe that with time, whether less or more, people lose the drive for their jobs. They lose capacity to see, supervisory also.

**JK: How much of the decision making power is under your control? How are you reviewed and monitored?**

RM: This varies even in BCP it varies. As I said one thing is formal and one is informal. In Romania, we had one of the systems I liked the most. Where we managed the company through committees, the bank had 12-13 committees: IT, security, commercial, management, in the end, we break the company into committees, and you have executives and first line management and the decision making process is collective. One thing for sure is that you cannot give full power to a CEO or transform executives into mini CEOs. I believe the involvement of several levels of hierarchy, improves quality of decision. You need proper rules and you need to follow them strictly, you have decisions and consulting bodies and after all that you arrive to the executive officer, but in the end the decision was made collectively. Decisions that are important for bank are made collectively, then in the end I have the mandate to implement them. Decisions are part of process and you should stick to it properly. Decisions assigned by statute, I follow the process and law closely. In an organization you do not have "friends", and you don't base your decisions on personal relations.

**JK: Do you have any insurance coverage for mismanagement mishaps? Does that help encourage in your opinion, more risk taking behavior?**

RM: Of course we call them D&Os – Directors' and Officers' policies. It covers everything until gross negligence. Usually you have a coverage for directors. I was a member of the insurance of BCP since junior. This covers legal expenses and fines and claims up to negligence. You have several degrees, negligence is when you don't do an action or do an action that doesn't intend to have a negative outcome. Gross negligence is above that, it means you want to avoid the outcome but there is nothing you can do, so you don't do anything.

**JK: As a bank, what are the precautions that were taken post the crisis to ensure another bankruptcy such as the one in 2012 wouldn't occur?**

RM: You cannot avoid a crisis. You had here an excess credit crisis. You can debate all the causes, but we ended up with a huge public debt. This is unfortunate and this happens regularly and people don't understand the reasons, in 10-30 years people will forget and have another. Banks are not at the core of the crisis. I believe without healthier banks finance wise and without prudent management and good credit decision criteria, of course you will not solve this crisis. You have people and companies in



excessive debt. This takes generations to solve. Banks won't solve a crisis, they will try to avoid contributing to further crisis. I believe our management understands that you cannot be an excessive risk taker but all this takes time.

Also the regulation, we have a very comprehensive framework regulation, ... that helps regulate banks better. Although I believe the system is still struggling and you need a balance, here we have an imbalance between regulators and actors.

SSM – the EU created a system: you had Basel 2 that was the basic framework for the banks. Then it evolved to Basel 3. So this goes into SSM. Then we have a regulation that says how to compute capital... you have EBA that interprets regulations... you have Banking Union.. ECB regulator of systemic bank.. BCP today is regulated by a single entity. The issue is the contamination of public debt with bank debt and we should avoid transmitting issues. They want to split the banks from the system.

**JK: Were there prosecutions following the incidents in 2007? Was it efficient or fair?** In 2007, Millennium BCP faced turmoil amid probes of its accounts by Portuguese financial crime investigators, the central bank (Banco de Portugal) and stock market authorities (CMVM). The findings of an investigation by the CMVM suspected the existence of several off-shore companies which Millennium BCP might have used to buy its own shares when it increased its capital in 2000 and 2001.

Several managers are in court till today and they are not finally convicted. They have several convictions but nothing final. I don't want to make a statement. I believe process wise it is taking too long and if they are innocent it's destructive if they are guilty, they won't serve the community well. You have 3 entities involved, Bank of Portugal CMVM and.... One of cases went to a low tier judge... we have a lack of expertise. Changing the legal system in Portugal is impossible.

**JK: I heard that in Portugal, the problem was not in the regulations per se, but in the application of the procedures and follow through, could you comment on that?**

RM: In Portugal our problem is not lack of rules it is a matter of lack of understanding of what are the responsibilities and duties from all entities involved in management and supervision of a company etc. What we tend to see in cases recently is a complete decoupling between formal power and informal power in the end you have very straightforward rules but the informal way of deciding was completely short-circuiting whatever rules were in place. Why? Because you have someone like the CEO who had most of the power, and everyone who was supposed to supervise were not doing so, and you have a lot of reasons for that.

Some examples: we invite someone to be a board member, and he knows he doesn't have the profile, and we know it but again the correct procedures are not adopted. PT was for example run with the management of a small shareholder. Ricardo Salgado was running not only BES but also PT. It is a matter of people there that don't exercise their duties. This related of course with the way business is done.

**JK: would you describe this entire problem as a cultural problem?**

RM: Yes for sure and I hope younger generations create the grounds for this to change. You see this everywhere.



**JK: But if these problems were a culture issue then how come other examples of Portuguese companies succeed and excel? Namely: Sonae, JM, etc.**

RM: Well you have disasters everywhere, in the US and elsewhere. There are different backgrounds for why people do such things. In Portugal, you have a tendency to create a myth. You had several managers that you had promoted to the Olympus, and no one would question what they were doing. We had a dictatorship that created such a cultural issue.

**JK: Are there any examples you would follow from any other countries?**

RM: What I like in the US is how fast they solve their legal issues. I would like to have things sped up in Portugal.

**JK: Could you comment on the tax debates in Portugal and in specific the situations where executives are personally liable for a company failure in paying the necessary tax.**

Regarding taxes we have always a huge tension between interest of community and protection of private entity. And in Portugal you see a drift, where private individuals and companies are increasingly unprotected by some form of abuse by tax authorities. Managers have a responsibility subsidiary for taxes. I believe the tax authorities are becoming abusive to everyone. A trend that we see and it is obvious where 20 years ago people evaded and they created a robust machine to crack cases... and people are caught.

### **11.3. Interview with Professor Duarte Pitta Ferraz:**

DPF: With the crisis, Managers became more cautious of the mistakes they made very often provoked by a wave of making investments without thinking much about them and about their yields or profitability or risk profile. Also because banks and companies due to the losses they suffered and lack of liquidity and capital were forced to become cautious and prioritize where they were investing.

Today the trend is to be risk adverse and risk cautious when making decisions. So people started thinking that making investments where they don't consider these issues, might strike them back.

**JK: Do you think the law in Portugal or other areas might induce these behaviors towards risk?**

DPF: I believe the crisis provoked the change. We can see that companies did not have very rigid or defined policy for investments and the crisis that impacted the available liquidity and capital made people think about also in the banks as they're the suppliers of liquidity while shareholders supply capital. But the banks became also very risk adverse. More over you must consider the load to deposit threshold P, Spain, Greece, Italy and Ireland where banks lent more money than they had in deposits. Another problem was that they had a mismatch between maturity of deposits is very short and maturity of loans much longer. I do not believe it was the law at first although the law and the regulations had a strong impact.

With the publication of Basel 3 – rules and regulations issued by BIS, imposed minimal levels of liquidity and capital to the banks and imposed higher minimal levels. Tier 1, ratio of capital used to be in many banks between 2 and 4% and Basel 3 started imposing 8% and countries now impose 10 and 12 in which Portugal is included.

**JK: Do you find that the judiciary system in Portugal encourages investment or it is too bureaucratic and rigid?**

The major problem for FDI in Portugal is related to the crisis that we are living that made very unstable the Portuguese corporate law and tax law frameworks. It is very difficult for an investor to invest where corporate tax and individual and social security contributions change at the speed they have been changing. Another barrier FDI faces in Portugal relates to the court, the way the courts operate which is perceived as being slow and therefore if a company has a problem it takes too long. Another is when companies have imp agreements or contracts they go for arbitral courts which means each appoints a judge and they make an agreement in the court but only possible between private companies. On a positive side you have a democratic country, where institutions generally work very well. You also have good staff and managers, highly qualified, you have a very good education system, a country with top infrastructures, in terms of highways airports and ports and healthcare systems and the fairly easy relationship with the government.

**JK: Could you comment on the tax system and authorities in Portugal and the impact they may have on executive management decisions? (One of the things that scare CEOs is what happens when the authorities suspect the company is not paying dues.)**

DPF: True it is a law that was passed not many years ago but today that the members of the board members of executive committee that have power of attorney of co may be liable personally for taxes but social securities that their employees don't pay to the government. So if they are managers and co is intermediate between employee and state, they have duty to deliver money they took from employees to state. It is a very difficult situation as people wonder if the jobs they have compensate for this risk, so they are having insurance that covers the risk. Above that issue, there is a new trend in Europe being discussed and in Sweden seems will be applied. In banks the authorities considering to forbid that a bank executive is not allowed to wave his or her responsibility financial responsibility with an insurance coverage to cover his or her responsibility if there is mismanagement.

When I was on the board of Baft in Washington, the bank I worked for, I had insurance – unlimited responsibility insurance if I made any mistake in any decision I would be liable to. There is an exception, if you act without – juridical figure called DOLO – which is when you commit a crime with intention to do a bad thing to someone or an institution, but DOLO, insurance never covers but DOLO is very difficult to prove.

**JK: How many CEOs or executives were actually prosecuted in Portugal under bad faith or negligence or mismanagement?**

DPF: There is the Vice chairman of millennium, Armando Vara that was condemned to 5 years in prison although still under appeal – because of some corruption where he influenced people from government like EDP. Also, Maria de Lourdes Rodrigues – former minister of education, she was condemned for some decisions she made – also under appeal. In large corporations, I am aware of Joao Cebola de Oliva that was in jail because of not delivering the VAT to the government.

But yes it is true that not many CEOs have been put in jail or in court because of decisions made in their companies. It also happened with BPN but it was a situation where they were stealing the money clearly a situation less sophisticated than BES.

**JK: Do you see a problem with the monitoring of the actions of CEOs?**

DPF: The problem for me is that in Portugal the non-executive directors are not independent. The law imposes a majority of non-exec directors called NEDS but when u look there is not as to approve names of non-executive directors. This regulation is restricted to financial institutions not general. I also don't believe that the scrutiny performed about their CVs is serious. Meaning detailed and looks into their relationships.

You have in Portugal two systems of corporate governance: A dual system of 2 boards where you have a conselho geral and supervisão, general council board and supervision and then the executive committee. Then you have another model composed of 1 board with exec and non-exec, which is even better, such as the situation of PT. What I would say is the code of corporate law has to be reviewed in light of the recent scandals in Portugal.

**JK: What is the mandate and conditions for CEOs to keep their position in Portugal?**

DPF: It is one big problem as CEOs in Portugal stay in their positions as long as they can and therefore as we see in other professions such as auditors, the law should establish a maximum number of years that they can stay in those positions. I would say that we need to make sure the NEDs are independent for sure. And we should have in place a mechanism of scrutiny that ensures their independence.

The second thing is I believe that limiting number of mandates a CEO can have will contribute to more transparency and better governance. A good practice for me is what is done in Portugal now with regulators. They can only be on job for 6 years and it is a non-renewable mandate. At EIB I am a member of audit committee and I have a mandate of 6 years non renewable. When I sit in committee I don't care and don't make decisions thinking about re-election, I make what is good for bank.

**JK: Won't such time limit mandates make executives or board members short sighted?**

It might but we need to distinguish between exec and non-exec positions. It is a very perverse thing. In a Portuguese company, a CEO has been in place for 10 years, the chairman of supervisor committee who is also chairman of audit committee and member of the audit committee, in a company owned by government, is paid a hefty sum of money as a compensation. The Chairman is paid hundreds of thousands of euros a year with all additional perks.

When you look at a non-exec director making a huge salary and it is public information. Go to report of EDP, report of PT, report of TAP, and you can see the pays of chairmen, 700k, 1 million, 130k when u compare the salaries, you can see where their independence goes. This is a very difficult dilemma to sort out. You pay people well because you want them independent. If you don't pay them well they don't care they don't give a darn to what they're doing. But if you introduce a 3<sup>rd</sup> element: not paying well is bad. I agree they should be paid well but they should have a role as supervisor and at end of mandate they are out and its short period of time.

So when you think that to have a non-exec director with independent mind. 1) Relations with people in co should be close to zero 2) other factors affecting it that are attractive are people involved in politics that became non exec or chairman, I believe they are there for bad reasons – to influence government if a problem happens, not because of their prestige, it is only because of their influence (negative one) to achieve things that should be achieved by normal means. And have a limited of 1 mandate of 6 years.

As for the problem of shortsightedness, it is true but to avoid that the mechanism of supervisors like at EIB with a good model of governance, is that u don't replace a full board in one shot, but we have to challenge the current framework of corporate law in the world. We only change one person each year.

**JK: What is your opinion on different compensation schemes of executives and do you think they play a role in their decision-making?**

It should be a balanced system. I don't know in detail but u can see all salaries as its public.

A bigger problem in that is in Portugal, there is what we call compensation commission, that is a sub committee usually of board of directors. And people that are appointed to those commissions are also not independent. They are usually close curiously enough not to shareholders but to CEOs. Example BES. What we observe in Portugal is networks of personal relations.

**JK: Do you have any examples for bad investments that are not related to bad faith?**

DPF: Negligence, when in situation of PT, PT was presented to the minority shareholders and market as independent company with SH that had 10% was BES. However after crisis between both, we found out that CFO of PT was an employee of BES, as I mentioned simply personal benefits and relations.

Problem is that those personal relations talking about bad faith, I would say their decisions were to benefit the person that appointed them or the CEO of a SH that appointed them, favoring them clearly in investments. In ES family holding, bankrupt holding companies, without publicly disclosing in their annual report with 400 pages, that around 3 billion euros were deposited in a non-investment grade bank. I do not know if this qualifies as sophisticated corruption or bad faith but what I know is was not in interest of minority SH of PT. and these minority SH were hurt by the decisions of those managers... therefore it is even worse than bad faith.

**JK: Do you know of any executives that exhibited different values?**

Yes. Alexander Soares de Santos of JM was very good when decided to have a foundation where he donated money from his wealth. I think he learned a lot with Unilever, as they are partners. As well as Belmiro from Sonae. They set up a Supervisory board with foreigners and with people that think differently from their managers, both do that. Also, Antonio Serranha from CIM painting, Corporacao industrial du norte. Belmiro always ran sonae as base of meritocracy. Even now after he retired, Paulo was ceo, when he retired he appointed as Co-CEO. The difference between them and BES, they have structures where they listen to other people. While BES, Ricardo was not transparent

**JK: What is your opinion on the Business Judgment rule of Delaware State? Do you think it would make a difference in improving, facilitating or speeding up court processes in Portugal?**

DPF: No. I would add that they also have the duty to protect minority and other stakeholders. So this rule only protects executives. The problem is stakeholders of a company are so many that executives should be responsible for that. The pain they inflicted (BES and PT) on employees is something that should be considered. So I think that this rule is fine in the US but I think they have to be concerned about the impact of decisions and how they impact the big picture and stakeholders.

#### **11.4. Interview with Mr. Carlos Duarte**

Profession: CEO and founder of Marçal & Filhos Lda / Indufil / Caldeira Clemente & Ca Lda

Years of experience: 35 years

**JK: What incentivizes you to stay or move from a firm?**

CD: I want to stay in charge of the destiny of a firm, in order to pursue a personal project and its development.

**JK: And why Portugal?**

CD: Because I am Portuguese and I like my country, and so I will do everything to improve it within my humble possibilities.

**JK: Have you ever experienced working in a different country? How was it different?**

CD: Yes, I created a company in Spain. I didn't feel more difficulties than in Portugal, maybe because I already knew the country and its market and language.

**JK: What motivates you to work as Corporate Executive Office for a firm?**

CD: To lead a company, a team, coordinating all resources put available for its success.

**JK: Would you describe yourself as: Risk Averse – Neutral – Risk Taker?**

CD: I like to take risks, although calculated ones. Because every single decision attains risks, big or small.

**JK: What type of investments do you make?**

CD: Within the company, I make investments in several areas: Production technology; new products development; marketing and branding; human resources; communication; production capacity and environmental-friendly systems; products quality and certifications; customer service; investments.

**JK: How much of the decision making power is under your control?**

CD: Ultimately, I always have the last word, after discussing every issue with my team and advisors.

**JK: Do you have any insurance for the job? Who provides it? What percentage is it of your wage?**

CD: I do not have any type of warranty insurance. So basically I try to guarantee my future by planning my savings and investing on other areas.

**JK: Are you incentivized on a revenue basis or mainly a pay – check basis?**

CD: Only a fixed salary. Nevertheless, I make my best to guarantee that my team and myself has clear objectives, and has the motivation and resources to reach them.

**JK: Are there any restraining judiciary laws when it comes to taking a decision as CEO?**

CD: There's a big complexity in all the judiciary / commercial / fiscal / notary / administrative normative and rules. Often this complicates the decision-making. Overall, there is still a lot of bureaucracy. People have difficulties namely in obtaining industrial licensing.

**JK: How long does it take you to approve/ take a strategic decision?**

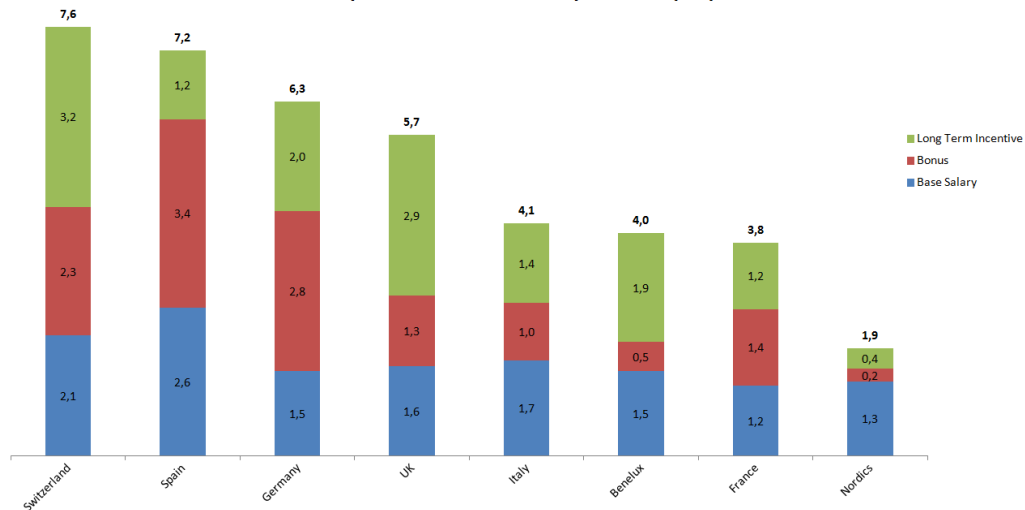
CD: After preliminary research and listening to the closer collaborators' opinions – the ones that may have more experience and skills in the specific subject matter – implementing a decision usually takes one or two months – depending on the complexity of the projects.

**JK: How do you feel about the judiciary system? Is it bureaucratic? Fair? Rigid? Lenient?**

CD: Unfortunately I do feel it's very bureaucratic, slow, rigid and unfair. But most of all, I feel it's extremely passive with those who break the rules.

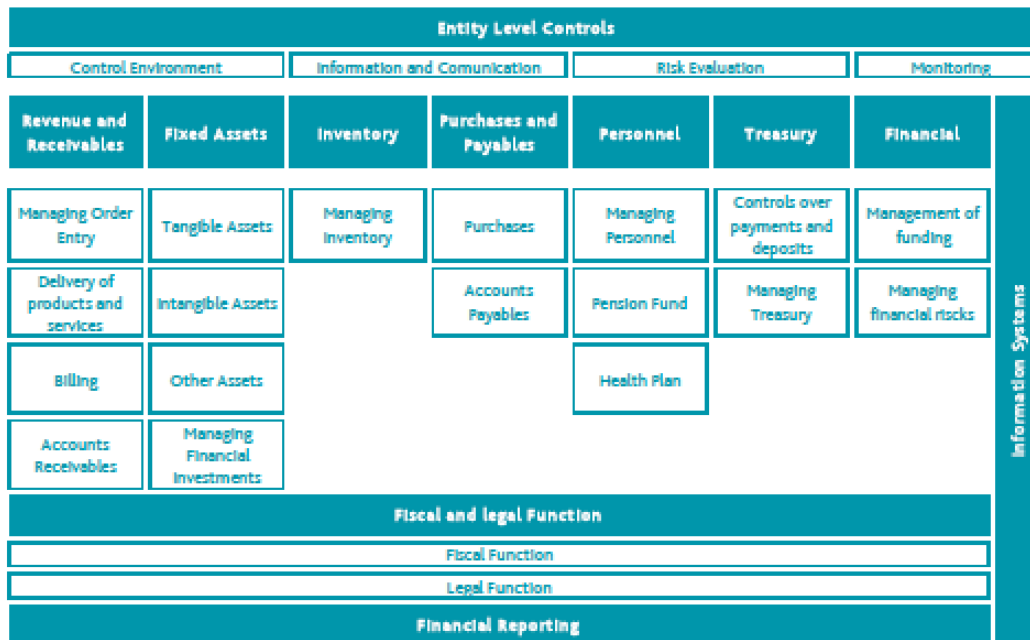
### 11.5. European CEO Median Compensation

2012 Eurotop100 CEOs Median Compensation (€m)



Source: Towers Watson "Board pay in the Eurotop 100" - September 2013.

### 11.6. Consolidated Annual Report of Portugal Telecom 2014 – CG structure



### 11.7. The Chronological relationship between GES and PT, an analysis by PwC, January 2015

April 5th 2000

This date records the celebration of a strategic partnership between PT, BES and CGD to strengthen their competitive positions in the field of "New Economy". Under this strategic partnership BES Group and CGD agreed to consider PT as the preferred provider of telecommunications services and, conversely, PT agreed to consider CGD and BES Group as its preferred suppliers of financial products and services.

2001

This date marks the beginning of the exposure of PT Group to GES bonds. On December 31st, 2001, PT's investment in GES amounted to € 600.2m. Over the years, this investment had reached the maximum amount of € 1.218m in 2005, and of € 897m in July 2014.

### **2003**

Corporate Governance scorecards were created reflecting the financial position of PT Group at a given time. Until the Corporate scorecards that were presented at the Executive Committee on 2 July 2014 by the CFO Eng. Luís Pacheco de Melo, the correct description of the issuer of the securities (ESI/RioForte) was never presented. The Executive Committee approved the corporate scorecards, although their presentation was not done regularly.

### **December 1st 2004**

Entry into force of the Service Order 2504, that stipulates that the delegation of powers conferred onto the Executive Committee by the Board of Directors, to individually appointed members. On Section 206 of Annex II of this Service Order, the Chief Executive Officer, the Executive Director responsible for finance and the Director of Corporate Finance had the power to make applications of cash surplus, through any of the legally permitted forms, by periods not exceeding 180 days, and without value limit.

### **December 23rd 2004**

Through DE 043504CE order, PT SGPS's Executive Committee decided to approve the implementation of a centralized management model treasury applicable to all PT Group companies in Portugal.

### **June 22nd 2007**

Approval on June 22nd, 2007, of statutory amendments introducing the Audit Committee in PT SGPS's governance structure.

### **February 2008 till September 2010**

There were no investments made by PT Group in securities issued by GES. Since 2007 the Audit Committee received from the Financial District, on request, the report of "Account Closure" that underpinned its quarterly opinion. The report structure designed by the Audit Committee (which is standard to the present time) had the 4th chapter entitled "unusual or relevant transactions" along the period. In this chapter, the investments made in GES / BES titles were never reported.

### **December 17th 2010**

Entry into force of Administrative Order 409, which defines the procedures and internal control mechanisms, which ensure the correct identification, approval and disclosure of, related party transactions. Subject to the exceptions provided for in the Service Order, when any transactions are concerned with related parties, the Board of Directors based on a prior opinion issued by the Audit Commission should approve them. Financial investments are not covered by the procedure described, due to immunity explained that Service Order. On February 23, 2011 comes into force Administrative Order 111, which currently is still in effect (and repealing Service Order 409), and which maintains an exemption from the need for approval by the Board and prior approval by of the Audit Committee, for financial investments with related parties, if carried out under market conditions.

### **June 21st 2010**

This date documents Vivo's share of the sale to Telefónica for the amount of € 7,500 m.



### **July 28th 2010**

The partnership with Oi involved an investment of up to € 3,700 m.

### **2012**

Governance Committee proposed that certain decisions of the Board, particularly with regard to financial transactions carried out by PT above a certain amount (provisionally defined in the analyzed proposal), had to start requiring prior approval of the Governance Committee. The Board never approved this proposal, as it was never presented to them.

### **May 3rd 2013**

PT SGPS, as the sole shareholder of PT Finance, approves the issuance of "notes" worth € 1 000m with a fixed rate of 4.625% and maturity on May 8, 2020. Part of this funding, € 500m, was used to acquire "notes" of ESI.

### **May 2013**

Increased exposure to securities of ESI, from € 510m to € 750m, on the same day that the amount of € 1000m issuance approved on May 3, 2013 was deposited in a checking account.

### **June 4th 2013**

PT SGPS announces that Zeinal Bava was taking over as chairman of Oi and that Henrique Granadeiro accumulated the positions of Chairman and CEO of PT SGPS. It is also reported that Zeinal Bava, as President of the Board of Directors of PT Portugal, will focus on strategic projects and innovation and joint work streams Oi / PT. Finally it was reported that the Luis Pacheco de Melo, as a member of the Executive Committee of PT and CFO of the PT Group, was to be elected Vice-Chairman of PT Portugal.

### **October 1st 2013**

PT SGPS and Oi (together with holdings of Oi) signed a MoU which defined the basic principles for a proposed merger between PT SGPS, Oi and also the holding of Oi, in order to constitute a single, integrated Brazilian listed company. In the MoU it was decided that PT would contribute in the capital increase of Oi with the "Assets PT" which were estimated to have a minimum of € 1 900m value and a maximum value of € 2 100m.

### **December 31st 2013**

RioForte acquired ES Irmãos. ES Irmãos, in turn would concentrate 10.3% of ESFG. The parties involved, particularly in terms of price did not disclose this operation.

### **January 22nd 2014**

Date of the conclusion of the acquisition by Rio Forte of the control of ESFG, upon a particular contract execution signed on 31 December 2013. This operation was not disclosed relatively to its price.

### **January 28th 2014**

BES meeting between the CFO of PT SGPS, Luís Pacheco de Melo and the CEO of BES, Ricardo Salgado, at the initiative of the latter to present Rio Forte. It was explained that the PT Group should start investing in commercial paper issued by Rio Forte instead of bonds issued by ESI. A presentation was delivered regarding the restructuring of GES, which did not mention the effects of operations described in "31 December 2013" and "22 January 2014" on the finances of Rioforte.

#### **February 10th till February 21st 2014**

Reimbursement of securities issued by ESI at the amount of € 750m. Subscription of commercial paper issued by Rio Forte of € 897m. The increased exposure to GES of € 750m to € 897m, was made using the time deposits demobilization in BES by total increase value (€ 147m). The period of financial investments was reduced, given the history of an average of 90 days to an average of 60 days, with the end date 15 and 17 April 2014.

#### **February 20th 2014**

Publication of the consolidated annual report of PT SGPS as at 31 December 2013, which in Note 24 - Short-term investments included debt securities amounting to € 750m, with the following note: "This caption includes debt securities issued by PT Finance and Portugal Telecom with a maturity of approximately two months and were settled in 2014 on due dates at their nominal value plus interest. " This note was incorrect since the bonds were not "issued" by PT Finance and PT SGPS, but signed. In addition, the note was incomplete, as it did not identify issuers of securities. In a statement dated 25 August 2014, PT SGPS gave at the request of the Portuguese Securities Market Commission, supplementary information to provide consolidated financial statements for the financial year 2013, which, among others, states that the debt securities of € 750m was subscribed by PT Finance and PT SGPS (and not "issued" as contained in the Annual Report) and that they were issued by ESI.

#### **March 25th 2014**

The Executive Committee of PT SGPS decided the passage of centralized treasury management of PT SGPS to PT Portugal as a result of the ongoing consolidation process of businesses. By virtue of this resolution the cash surpluses would start being controlled by PT Portugal.

#### **March 26th 2014**

BES meeting between the CFO of PT SGPS, Luís Pacheco de Melo, Carlos Cruz, finance director of PT SGPS, and BES CFO, Amílcar Morais Pires on the continuation of existing applications in commercial paper issued by Rio Forte. Luis Pacheco de Melo notes that the meeting took place at the request of Henrique Granadeiro. Amílcar Morais Pires notes that the meeting took place at the request of Ricardo Salgado and moreover that he would have stated that, in essence, everything was already agreed on the issue, between Ricardo Salgado, Henrique Granadeiro and Zeinal Bava.

#### **March 27th 2014**

PT shareholders at a General Meeting resolved on accepting PT's share in the capital increase of Oi, SA ("Oi").

#### **April 15th and April 17th 2014**

PT SGPS and PT renewed financial investments in commercial paper of Rio Forte worth € 897m.

#### **April 17th 2014**

Issuance of € 400m under " Agreement of Organization and Firm Placing of commercial paper" signed by PT SGPS, BESI and BES, starting April 23, 2014 and the repayment May 15, 2014 (22 days). The proceeds resulted from an increase in the existing ceiling of € 200m, approved at a meeting of the Executive Committee of 25 March 2014 (passed the amount available to be € 600m) in order to "increase the financial flexibility of the short PT term. "

Issuance of € 100m under "Agreement of Organization, Montage Placing, Subscription Guarantee, and Paying Agent and Registering institution of commercial paper issuance between PT SGPS and PT Portugal as issuers and Caixa BI and CGD as institutions", beginning on April 23, 2014 and the repayment May 15, 2014 (22 days). The funds resulted from the conclusion of the aforementioned agreement on April 16, 2014, approved at a meeting of the Executive Committee of 25 March 2014, for a maximum amount of commercial paper of € 200m.

#### **April 23rd 2014**

Use of € 300m through the Facility B on April 23, 2014 for a period of one month, under the "Term and Revolving Credit Facilities Agreement" dated June 29, 2012.

#### **April 24th 2014**

€ 55m issued under "Agreement of Organization, Montage Placing, Subscription Guarantee, and Paying Agent and Registering institution of commercial paper issuance between PT SGPS and PT Portugal as issuers and Caixa BI and CGD as institutions", beginning on April 29, 2014 and the repayment May 15, 2014 (16 days). The funds resulted from the conclusion of the said contract.

#### **May 5th 2014**

Settlement by the PT Group of R \$ 4 788m (€ 1 550m) in the capital increase of Oi defined in the MoU. Note however that the amount transferred to Brazil was € 1 302.5m, since other entities owned by PT and headquartered in Brazil had already left the required value to total R \$ 4.788m, for what the amounts used were issued in 17, 23, and April 24, 2014 totaling € 855m.

Conclusion of an agreement between PT SGPS and PT Portugal, in which are transferred, among other assets, € 200m in commercial paper of Rio Forte PT SGPS for PT Portugal.

In this capital increase, as announced to the market the May 6, 2014, were distributed 1.865.954.588 3.696.207.346 ordinary shares and preference shares under the Brazilian Offering and 396,589,982 ordinary shares and 828,881,795 preference shares in the Offering international, with the final capture the gross amount of R \$ 13.96 billion, of which R \$ 8.25 billion in cash and R \$ 5.71 billion in invested assets by Portugal Telecom SGPS SA.

#### **June 27th 2014**

BES sent to PT SGPS the Annual Report of Rio Forte for the year that ended on December 31, 2013, dated March 21, 2014, whose opinion of Auditors includes an emphasis as follows: Without qualifying our opinion, we draw attention to the acquisition of a significant stake in Espírito Santo Financial Group, financed through short-term debt instruments, resulting in an excess of current liabilities over current assets. As disclosed in Note 2.1, the Company is developing the necessary actions to strengthen its working capital by extending the maturity of its debt instruments. The success of this process is uncertain at this moment as it is at an early stage."

#### **June 30th 2014**

PT SGPS issues a press release signed by the Chairman of the Board of Directors, Henrique Granadeiro, and the CFO, Luís Pacheco de Melo, which clarifies that, at the date of the document, PT Finance and PT Portugal had applications € 897m in commercial paper of Rio Forte with maturities on 15 and 17 July 2014.

#### **July 10th 2014**

Presentation to the Board of Directors of PT SGPS of the first report of the Audit Committee on the application of cash surpluses in the GES.

**July 15th and July 17th 2014**

Rio Forte cannot repay the principal and interest resulting from the subscription of € 897m of commercial paper by PT Finance and PT Portugal.

**July 22nd 2014**

Rio Forte enters the request for controlled management in the Luxembourg Court.

**July 25th and August 5th 2014**

Presentation to the Board of Directors of PT SGPS of the second and third Audit Committee reports on the application of cash surpluses in GES.

**July 1st till July 30th 2014**

Fernando Magalhães Portella, Otavio Marques de Azevedo, Amílcar Carlos Ferreira de Moraes Pires and Joaquim Anibal Brito Freixial de Goes resigned from their positions as non-executive members of the Board of Directors of PT.

**August 7th 2014**

Henrique Granadeiro informs the Board of Directors that he presented the resignation of all the functions that holds on the Board of Directors of PT.

**September 8th 2014**

Shareholders gathered at the General Meeting and decided on the terms of agreements between PT and Oi under the combination of the businesses of the two companies.

**September 18th till November 5th 2014**

Were appointed by cooptation, as non-executive members of the Board of Directors of PT, to complete the term of office (2012-2014), Rolando Antonio Durão Ferreira de Oliveira, Francisco Ravara Cary, Marco Norci Schroeder, Eurico de Jesus Neto and Teles Jorge Freire Cardoso to replace Henrique Manuel Fusco Granadeiro, Amílcar Carlos Ferreira de Moraes Pires, Otavio Marques de Azevedo, Fernando Magalhães Portella and Joaquim Anibal Brito Freixial de Goes, respectively.

It has also been decided to appoint by co-option the administrator João Manuel de Mello Franco to exercise the role of Chairman of the Board of Directors of PT.

**November 27th 2014**

According to a financial analysis presented to the Board of Directors, the integration of ESFG in Rio Forte had a negative impact on the value of it which amounts between € 1600m and € 1900m. There are indications that this impact was the knowledge of the marketing entity (BES) to the date of the first subscription by PT SGPS commercial paper issued by Rio Forte in February 2014.

**December 8th 2014**

Luxembourg court confirmed the insolvency declaration of RioForte.

**2010 till 2014**

The subscription of bonds / commercial paper issued by GES along the period was always performed under Service Order 2504 and Administrative Order 111 and as such was never object of approval nor of prior appraisal by the Board of Directors, by Executive Committee nor by the Audit Committee.